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## Eminent Domain Economics: Should 'Just Compensation' be Abolished, and Would 'Takings Insurance' Work Instead?

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# **Eminent Domain Economics: Should “Just Compensation” Be Abolished, and Would “Takings Insurance” Work Instead?**

STEVE P. CALANDRILLO\*

*In a defeat for staunch property rights advocates, the Supreme Court ruled last year that a prohibition on land development in the Tahoe basin did not amount to a de facto taking of property requiring “just compensation” under the Constitution. The Tahoe decision highlights the struggle in eminent domain jurisprudence over the proper treatment of so-called “regulatory” takings. It has long been taken for granted that when the government exercises its power of eminent domain to take private property in the name of the public good, it must reimburse displaced landowners. While compensation for physical takings of land is thus rarely subject to serious debate, the same cannot be said when the state utilizes its police power to regulate for the public benefit. Often, zoning ordinances banning commercial or residential development effect financial hardship on property owners similar to an outright procurement of their land—either way, much of their land value may be destroyed. In the past decade since the landmark Lucas case was decided, the Supreme Court accommodated this reality by mandating just compensation for any regulatory action that deprived a property owner of substantially “all economically beneficial or productive use of land.” Now, after Tahoe, even that high threshold may not suffice to garner any reimbursement for regulatory takings.*

*The real question is: what should be done about compensating for eminent domain actions? This paper argues that society must no longer take the just compensation requirement for granted. Rather, a critical analysis of the effects of guaranteed state compensation reveals that it creates socially perverse incentives for landowners to excessively improve their land, and that government reimbursement is necessarily accompanied by non-trivial administrative and transaction costs. I will explore the possibility of abolishing the mandate of state-provided compensation, and replacing it with privately provided “takings insurance” instead. If society’s goal is reimbursement of impacted landowners, insurance could accomplish this end at least as well as government compensation could. Taxes that were previously used to fund just compensation could be returned to our citizens to enable them to purchase the necessary takings insurance. Additionally, private insurers could likely reduce the administrative costs involved in providing reimbursement, and better monitor the*

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*“excess improvement” problem by adjusting premiums charged to reflect changes in land values insured. Critics correctly contend, however, that the government will have a greater incentive to take land inappropriately if it no longer must pay for it, although this unfortunate consequence may not be as severe as some anticipate. Moreover, the moral hazard problem—that is, the fear that landowners now covered by insurance will submit to takings instead of fighting them—should not be significantly worse than it is today where just compensation is guaranteed by our government. I further argue that the distributive impact of switching to takings insurance instead of state-based compensation will not disproportionately hurt the poor. Finally, under an insurance regime, the government may be led to take land in more socially optimal locations, rather than where it is politically expedient because poor or minority communities will be unable to put up a fair fight.*

*In the context of regulatory takings, however, it is not as clear that insurance-based compensation will be effective. It is quite challenging to accurately measure changes in land values due to myriad government actions, from the passage of various zoning ordinances governing commercial to residential to even wetlands development. Further, actors facing regulatory risks are often relatively risk-neutral, and moral hazard in the regulatory insurance market may pose a significant problem. Hence, neither insurance nor government-provided just compensation may function particularly well here, perhaps explaining the strict Tahoe standard just promulgated. We should admit, however, that there is no principled fairness-based reason for the Supreme Court’s current dichotomy in physical versus regulatory takings jurisprudence—in both instances, property owners are frequently left with little or no land value remaining. Instead, the differential treatment is better explained by the economic and practical realities of valuing and compensating for the different nature of the takings involved.*

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## I. INTRODUCTION

In a sharp blow to property rights advocates, the Supreme Court ruled last year that a Tahoe Planning Agency moratorium on land use and development did *not* amount to a government taking of property.<sup>1</sup> This would be a mere semantic issue but for the fact that the Court’s determination of what is versus what is not considered a “taking” is crucial in triggering the constitutional requirement that the government pay “just compensation” to the affected landowner.<sup>2</sup> It is common knowledge that the state must reimburse landowners when it exercises its power of eminent domain—for instance, when it commandeers private land in order to construct public roadways.<sup>3</sup> What is less widely known is that this requirement is often abdicated when the taking is of the mere regulatory variety, including zoning ordinances that prohibit all commercial or residential development (as in *Tahoe*). *Regulatory* takings are now to be very much

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<sup>1</sup> See *Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg’l Planning Agency*, 535 U.S. 302, 333–43 (2002). *Tahoe* marked a defeat for conservative defenders of strong private property rights, who had previously argued successfully for just compensation to be paid to landowners affected by a similar ban on land development in South Carolina. See *Lucas v. S.C. Coastal Council*, 505 U.S. 1003 (1992).

<sup>2</sup> See, e.g., *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104 (1978). In *Penn Central*, the Supreme Court struggled with the issue of what kind of government actions would constitute a “taking” such that just compensation would be required, admitting that it had been unable to find a satisfactory test for regulatory takings. See *id.* at 123–24.

<sup>3</sup> Eminent domain is generally defined as the power to take private property for public use (or for a public purpose) without the owner’s consent. See WILLIAM B. STOEBCUK & DALE A. WHITMAN, *THE LAW OF PROPERTY* § 9, at 524–25 (3d ed. 2000). The Fifth Amendment requires, however, that the government pay just compensation to displaced landowners. See U.S. CONST. amend. V (“[N]or shall private property be taken for public use, without just compensation.”).

distinguished from *physical* takings<sup>4</sup> of land: in the latter case, the landowner is constitutionally entitled to the fair market value of her property; in the former, she may very well receive nothing.<sup>5</sup> This difference is difficult to swallow if you are the victim of a regulatory taking: in both kinds of government actions, the landowner may be left with substantially reduced or virtually no land value remaining. Why should she be compensated only in the physical taking context? Is there a principled fairness-based justification for the distinction? Can economic theory offer a better explanation? Alternatively, should we simply abolish the government payment of just compensation for both types of takings so that our reimbursement policy does not discriminate between the two?

Part II of this paper explores the history behind the development of eminent domain law and government payment of just compensation in the United States. At the outset, we must address the justification for public provision of property, and ask why private supply cannot alleviate the government's need to engage in takings.<sup>6</sup> Unfortunately, private suppliers suffer from serious obstacles in their attempts to provide public goods (like roads and parks), including the reality that they must be able to charge a fee for use and prevent unauthorized use.<sup>7</sup> Private firms would also be unable to capture the full social value of items they build because of the necessity of charging one price (necessarily greater than \$0) to all users.<sup>8</sup> The government is therefore often the optimal provider of these goods, but of course, public provision requires land on which to build them. Purchasing that property on the open market frequently proves difficult because many homeowners are unwilling to sell at any price.<sup>9</sup> Others may hold out for

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<sup>4</sup> See *Tahoe*, 535 U.S. at 323–24 (noting that the “distinction between acquisitions of property for public use, on the one hand, and regulations prohibiting private uses, on the other, makes it inappropriate to treat cases involving physical takings as controlling precedents for the evaluation of a claim that there has been a ‘regulatory taking,’ and vice versa”) (internal footnotes omitted).

<sup>5</sup> See *id.* at 319–43.

<sup>6</sup> See EUGENE SILBERBERG, *PRINCIPLES OF MICROECONOMICS* 282–84 (2d ed. 1999) (detailing the special attributes and problems presented by “public goods”).

<sup>7</sup> See STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* § 11, at 2 (forthcoming 2003) (manuscript on file with author).

<sup>8</sup> See *id.* at 2–3. The “one price” assumption can be relaxed in certain instances where private producers are able to legally “price discriminate” between different types of consumers. *Id.*

<sup>9</sup> See generally DOMINIQUE Y. DUPONT & GABRIEL S. LEE, *THE ENDOWMENT EFFECT, STATUS QUO BIAS AND LOSS AVERSION: RATIONAL ALTERNATIVE EXPLANATION I* (2001) (detailing how the endowment effect drives a wedge between prices at which one is willing to sell versus willing to buy a good). The authors note that “[t]he discrepancy between the maximum willingness to pay for a good (“WTP”) and the minimum compensation demanded to part from the good (“WTA”) is a robust empirical observation in economics,” and they attempt to explain why people seem to prefer the status quo. *Id.*

exorbitant sums knowing that the state has no choice but to pay it.<sup>10</sup> The solution to this dilemma: the government's power of eminent domain.

The power of eminent domain entitles the state to procure private land for public use.<sup>11</sup> No consent is required—if the project is in the public interest and the government has undertaken to construct it, your land may be taken. However, there is the accompanying constraint that “just compensation” be paid to reimburse the property owner for her loss.<sup>12</sup>

When eminent domain is discussed, most people think of the *physical* acquisition of land. Traditionally, the state has exercised its power of eminent domain to procure land for the construction of roads and bridges and parks, among many other public goods.<sup>13</sup> The principle is that by doing so, the state will serve society's overall interests more than it will inconvenience the comparatively few property owners affected.<sup>14</sup> Naturally, we think it only fair that the state compensate these individuals for taking their property, leaving them with the monetary equivalent of what they previously possessed. The Fifth Amendment to the Constitution explicitly requires this outcome as well, stating: “nor shall private property be taken for public use without just compensation.”<sup>15</sup> This sounds quite reasonable, and reflects intuitive notions of corrective justice.

In recent decades, however, *regulatory* takings have become far more prevalent.<sup>16</sup> They include zoning ordinances, moderate restrictions and even outright bans on commercial and residential development.<sup>17</sup> Where do we draw the line regarding what actions count as “takings” necessitating government reimbursement? All kinds of state decisions affect property values, from whether or not to build a school, library or prison, or pass a zoning regulation in a given neighborhood. If the state were required to compensate property owners every

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<sup>10</sup> See SILBERBERG, *supra* note 6, at 288.

<sup>11</sup> See STOEBUCK & WHITMAN, *supra* note 3, at 524–25.

<sup>12</sup> See U.S. CONST. amend. V.

<sup>13</sup> For example, much of America's extensive interstate transportation system was made possible by the government's socially beneficial use of eminent domain to procure the land necessary. Moreover, parks such as the Cape Cod National Seashore and the Minute Man National Historical Park were made possible in part by government land takings. See Steven A. Hemmat, Comment, *Parks, People, and Private Property: The National Park Service and Eminent Domain*, 16 ENVTL. L. 935, 936 (1986).

<sup>14</sup> However, anyone who has ever attended a county council meeting where irate local landowners were faced with the prospect of property loss in the name of the public good might legitimately question whether the gain provided outweighed their individual anger and loss.

<sup>15</sup> U.S. CONST. amend. V.

<sup>16</sup> See STOEBUCK & WHITMAN, *supra* note 3, at 527–35 (detailing the evolution of takings over the past several decades).

<sup>17</sup> See SILBERBERG, *supra* note 6, at 288 (discussing various zoning ordinances as a solution to inefficiencies in the private market and describing single-family zoning, height restrictions, and “set-back” provisions, among several others).

time its actions impacted land values, government operation would be impossibly impractical.<sup>18</sup> In the past, courts dealt with the slippery slope problem of the potentially limitless extension of the just compensation requirement by separating out those regulatory takings from the physical variety. In a landmark decision ten years ago, *Lucas v. South Carolina Coastal Council*,<sup>19</sup> the Supreme Court held that only if substantially “all economically beneficial or productive use of land” was taken may the property owner recover for a regulatory taking.<sup>20</sup> Now, after *Tahoe*, it is not clear that even that high threshold will suffice to garner the landowner any compensation.<sup>21</sup>

Part III of this paper analyzes the takings problem from an economic perspective, inquiring in Part III.A whether the requirement of just compensation for *any* form of government taking is necessary. Part III.B details the drawbacks of just compensation that society rarely considers, providing a foundation for the argument that we should abolish the requirement that the government reimburse displaced landowners.<sup>22</sup> The current guarantee of state-paid compensation unintentionally gives property owners excess incentives to make improvements to their land, because they know that reimbursement for the increased property value will be paid regardless of whether the government eventually decides to take their land and demolish their improved structures.<sup>23</sup> Moreover, mandatory government reimbursement generates large administrative costs in the form of increased taxes to fund and pay out the compensation necessary. Nevertheless, the draconian alternative of eliminating just compensation altogether understandably seems like a radical and unbearably insensitive idea to many when they first hear of it.

However, Part III.C argues that the harshness of abolishing government-provided reimbursement is alleviated by replacing it with a private insurance market to protect landowners against the risk that eminent domain will rear its head on their land. “Takings insurance” would emerge to fill the void left by government reimbursement, and be much like the myriad insurance coverages that property owners currently purchase. For example, when one buys a home, she typically is required by the mortgage company to purchase title insurance to

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<sup>18</sup> See *Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency*, 535 U.S. 302, 323–24 (2002) (describing the impracticality of running a government where all of its actions would be subject to compensatory disbursements).

<sup>19</sup> 505 U.S. 1003 (1992).

<sup>20</sup> *Id.* at 1015.

<sup>21</sup> See *Tahoe*, 535 U.S. at 332 (noting that the categorical rule of regulatory takings laid down in *Lucas* was carved out for an “extraordinary case,” and that the default rule remains that a more fact specific inquiry is required).

<sup>22</sup> See SHAVELL, *supra* note 7, § 11, at 13–14 (arguing that highly developed insurance markets remove the need for government compensation for takings).

<sup>23</sup> See *id.* § 11, at 15–17 (arguing that homeowners will be willing to take the risk of constructing improvements considering that compensation in the event of a taking will account for such improvements); see also *infra* Part III.B.1.



protect against risks of defects in the chain of ownership, and homeowner's insurance to guard against fire, theft and many other unpleasant events.<sup>24</sup> The traditional justification is that insurance helps protect against the risk of these low probability, but highly detrimental and value-destroying contingencies.<sup>25</sup> Similarly, why couldn't the homeowner also buy takings insurance to protect against the risk that the government might one day see a beneficial public use for her land and decide to build a road directly through it? Or, perhaps the state may someday decide to regulate in the public interest by preserving her property as a natural wetland, and hence prohibit it from being developed in accordance with the owner's prior investment plans.<sup>26</sup> Either way, a private insurance market might substitute quite well and function even more efficiently in providing reimbursement than mandatory government compensation does today.<sup>27</sup> Moreover, the tax dollars that were formerly used to fund government reimbursement could be returned to the pockets of our citizens to enable them to purchase the necessary takings insurance, hopefully accompanied by a cost-savings in terms of total expenditures.

Part III.D explores the appeal and effects of switching to a private takings insurance market in lieu of the constitutional mandate of just compensation. I will ask whether or not insurance would likely emerge in reality to reimburse landowners against the risks outlined above. More importantly, I will address the advantages and disadvantages that an insurance-based alternative to government-provided just compensation would present. Takings insurance would ideally reduce the administrative costs of compensating landowners compared to government reimbursement, and discourage excessive improvements to property in the face of looming eminent domain actions—because premiums could be

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<sup>24</sup> See generally Ins. Info. Inst., Homepage, at <http://www.iii.org> (last visited Apr. 7, 2003) (indicating that insurance coverage is offered for automobiles, homes, businesses, disabilities, life, natural disasters, and numerous other contingencies).

<sup>25</sup> See, e.g., ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 49 (3d ed. 2000); SHAVELL, *supra* note 7, § 5, at 7 (discussing the desirability of providing insurance coverage to all risk-averse individuals); Yvonne Catharina Maria Jonk, Insuring the Uninsured: An Analysis of the Degree of Risk Aversion and the Demand for Health Insurance in the State of Minnesota 14–15 (2000) (unpublished Ph.D. thesis, University of Minnesota).

<sup>26</sup> This fact pattern is not very different from that of *Lucas*, where the South Carolina Beachfront Management Act barred landowners from erecting any permanent habitable structures on the regulated land in order to preserve its natural state for posterity. The Petitioner, David Lucas, argued that he had purchased two lots on a South Carolina barrier island intending to build single-family homes such as those on the immediately adjacent parcels. His reasonable development expectations were therefore violated by the Council's ordinance, and the Court ruled he was in fact entitled to reimbursement. See *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1007–08, 1019–32 (1992).

<sup>27</sup> While Parts III.C and III.D will discuss the advantages of insurance in lieu of government reimbursement in the physical takings context, such an alternative might run into serious obstacles with respect to compensating for regulatory takings. See *infra* Part IV.

adjusted to reflect changes in property value insured. In this manner, homeowners would be led to balance the benefits of potential improvements against their full costs, which would incorporate increased takings insurance premiums to reflect greater expected liability in the event of a taking. However, many reasonable commentators view the Constitution's requirement of government-based reimbursement as an important constraint on public decision-making.<sup>28</sup> Some fear that if the state were released from its obligation to compensate landowners, it would overzealously use—or even abuse—its eminent domain power to take far more land than it does today. This problem is not merely an academic concern, and is perhaps the greatest obstacle in the path of switching to private takings insurance.

Part IV analyzes the special problem of regulatory takings. While an insurance scheme in lieu of state-provided reimbursement has appeal for physical takings of land, it is problematic in the regulatory takings arena. Part IV.A discusses the unique issues that regulatory actions pose, and Part IV.B offers an economic theory explanation for the Supreme Court's latest jurisprudence on the subject. It seems incongruous to provide compensation for physical land takings based upon the principle of fairness, and then to deny that same reimbursement for regulatory takings that destroy similar land value. Economic analysis offers a functional theory to support the distinction, concentrating on the practical difficulties inherent in estimating declines in market value due to regulations, as opposed to complete eliminations in value caused by outright physical takings. Additionally, moral hazard and adverse selection problems appear to be more severe in the regulatory takings context than they do with respect to physical land takings.

In the final analysis then, both state payment of just compensation and the alternative of a private takings insurance market may not work effectively when it comes to reimbursing for regulatory actions. Hence, property owners may be left justifiably aggrieved when faced with a zoning ordinance that destroys much of their entire land value. We should be honest enough to admit to them that there is no fairness or justice-based explanation for that deprivation, and instead focus on understanding the economic and functional realities that result in the law's shortchanging of regulatory takings.

Society must also take the lessons learned from our analysis of takings jurisprudence and theory to suggest ways to improve the current system of

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<sup>28</sup> See generally JOHN P. DWYER & PETER S. MENELL, *PROPERTY LAW AND POLICY: A COMPARATIVE INSTITUTIONAL PERSPECTIVE* 893–95 (2001) (discussing the contributions of the public choice literature with respect to the Madisonian vision of representative government as a rational process yielding public-regarding legislation). The implication made by public choice theorists is that government legislators respond far more directly to interest group demand and incentives instead of taking actions that are necessarily in the interest of the overall public. *Id.* In this context, the Fifth Amendment's requirement that the state pay compensation for eminent domain actions can be seen as a crucial constraint on potential abuse of the power. *Id.*

eminent domain reimbursement. Most notably, the mandatory payment of just compensation should not be taken for granted as it is so often today. Rather, a critical analysis of its goals and effects is required in order to improve social welfare. We must evaluate ways to alleviate the excess improvement incentives created by the current reimbursement structure, and seriously consider replacing the requirement of government-paid compensation with a more effective and efficient insurance-based alternative, at least and especially in the physical land takings context.

## II. PUBLIC PROPERTY AND THE LAW OF GOVERNMENT TAKINGS

### A. *Why Do We Need Public Provision of Property?*

Before an analysis of takings law can begin, we must first ask the question: why do we need public provision of property at all?<sup>29</sup> Some would suggest that a private company could purchase the necessary land on the open market and construct the desired roads and parks if they were of value. Since so much property in America is publicly owned and provided, we must address the justifications for public ownership in order to understand the principles behind the power of eminent domain.

#### 1. *When Should a Bridge Be Built?*

Let's imagine that the government is considering the construction of a bridge that would link San Francisco and Oakland. The cost to develop this bridge is largely a one-time, upfront cost. The piles must be driven, the concrete poured, the span erected, and then the bridge is up and running.<sup>30</sup> Let's make the further simplifying assumption that once the bridge is built, there are minimal or no additional costs associated with each individual's use of it. One can drive her car across the span without reducing its value or utility to future drivers.

Given these assumptions, the state (or a private builder as well) must ask itself: should we go ahead and build the bridge? From society's perspective, the answer is found by asking whether the sum of the utilities to all possible users by virtue of having access to this bridge exceeds the one-time construction cost.<sup>31</sup> Assuming that there truly is zero marginal cost per use,<sup>32</sup> it is socially desirable

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<sup>29</sup> See, e.g., SILBERBERG, *supra* note 6, at 282–84 (illustrating examples of goods that should be publicly provided in order to maximize social welfare).

<sup>30</sup> Interview with J. Irwin Yoon, former civil engineer with Ben C. Gerwick, Inc. (Oct. 5, 2002) (detailing bridge construction).

<sup>31</sup> See SILBERBERG, *supra* note 6, at 283–84.

<sup>32</sup> Economists often start with the generalized assumption that roads, bridges and parks entail significant one-time costs, and involve zero marginal costs per use. See *id.* In reality, there is some incremental cost associated with each additional user (i.e., goods are not perfectly “non-

that the bridge be built if the total value to all of the potential users is greater than the cost of construction.<sup>33</sup> Moreover, from society's perspective, we should let all drivers have access to the span for *free* since they impose no incremental costs each time they drive across it.<sup>34</sup> Hence, both public provision of this property and free use increases social welfare. The question arises however, what would we expect to happen if the government chose not to build this bridge? Why couldn't a private firm construct it just as well?

## 2. Problems Associated with Private Supply

Naturally, one might think that the private sector would erect roads or bridges if the value to users exceeded the builder's cost. Presumably, a private company could collect payment from users to fund the construction, much like our tax dollars support public construction today. However, several problems of private supply would likely infect the process.<sup>35</sup>

### a. Ability to Charge a Fee for Use

First, in order to recover its costs, a private provider must be able to charge a fee for use.<sup>36</sup> It would need to erect a tollbooth to charge drivers as they entered the roadway and keep it staffed with employees to maintain and manage the bridge's use. Closely related to the ability to charge a fee, the private producer must also be able to prevent unauthorized, unpaid-for use—otherwise, each individual would have an incentive to free ride off of the fees being paid by others.<sup>37</sup>

The need to charge a fee and to restrict unlawful use might prevent the development of the project altogether, or at the very least, increase the cost to the private supplier relative to that of the state—which can raise funds to cover its

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rivalrous"). Each car added to the road inflicts some wear and tear that eventually will need repair, and each individual adds to overall congestion, decreasing the value that other users obtain. For simplicity, however, it is easy to view large public projects such as road construction as involving one-time fixed costs, since the incremental cost per user is substantially less than the upfront development cost. *Id.*

<sup>33</sup> See *id.* at 284.

<sup>34</sup> See *id.* at 283–84.

<sup>35</sup> See ROY J. RUFFIN & PAUL R. GREGORY, *PRINCIPLES OF MICROECONOMICS* 60 (4th ed. 1990) (noting that private competitive markets will fail to supply public goods).

<sup>36</sup> See SHAVELL, *supra* note 7, § 11, at 2; see also COOTER & ULEN, *supra* note 25, at 161 (observing that transaction costs make private supply of public goods prohibitively difficult because public and private entities have to work closely together in such an arrangement).

<sup>37</sup> See EDWARD M. GRAMLICH, *A GUIDE TO BENEFIT-COST ANALYSIS* 17–18 (2d ed. 1990) (discussing the problem of “free riding,” and noting that private market mechanisms for achieving a social optimum theoretically exist but that a feasible system would be quite difficult to work out).

costs through taxes instead of charging a fee for use.<sup>38</sup> One might also imagine certain types of public goods for which the ability to charge any fee at all would be close to impossible. For instance, take the example of a lighthouse off Cape Cod.<sup>39</sup> Its construction would entail a one-time fixed cost, and zero marginal cost per use. Boats passing by would benefit by being better able to demarcate the boundaries of land and sea, and hence would presumably be willing to pay in order to have the lighthouse built. However, it would be exceedingly difficult for a private provider to charge ships passing by. She would not know who all of the users were, it would be prohibitively expensive to set up a monitoring mechanism, and so one quickly realizes it is not worth the time or money to invest in private lighthouse construction.<sup>40</sup> The only practical solution is for the government to build it, since no private producer will effectively be able to charge for the service provided.<sup>41</sup> Thus, when it is unrealistic for a private producer to charge a fee for use, public provision is required.

#### *b. Accounting for Varying Levels of Utility in Different Users*

Even where charging a fee is possible, private supply suffers from the problem that it cannot capture all of the utility that different individuals derive from using roads or bridges or lighthouses.<sup>42</sup> A private supplier (let us imagine a monopolist), would attempt to maximize revenues in deciding what fee to charge users.<sup>43</sup> Let us assume that the total cost to build the bridge is \$400. Let us also assume that there are ten possible users in the world that would obtain varying levels of utility from the construction and use of a bridge:

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<sup>38</sup> See SHAVELL, *supra* note 7, § 11, at 2–3.

<sup>39</sup> See R.H. Coase, *The Lighthouse in Economics*, 17 J.L. & ECON. 357 (1974), reprinted in R.H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 187–213 (1988). Coase describes the private provision of lighthouses in 17th to 19th century England and Wales, providing a counterexample to the contention that lighthouses could never be privately supplied due to the inability to collect fees. But in actuality, Shavell notes that Coase describes methods by which fees were collected by customs agents when ships came into port (rather than the collection of fees from ships passing by and using the light). See STEVEN SHAVELL, *INSTRUCTOR'S GUIDE TO FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* § 11, at 4 (forthcoming 2003) (manuscript on file with author) (stating that the collection of fees must be publicly coordinated for lighthouses to be feasible).

<sup>40</sup> See SHAVELL, *supra* note 39, § 11, at 4.

<sup>41</sup> See *id.*

<sup>42</sup> See ARMEN ALCHIAN & WILLIAM R. ALLEN, *EXCHANGE & PRODUCTION: COMPETITION, COORDINATION, & CONTROL* 99–101 (3d ed. 1983); see also SHAVELL, *supra* note 7, § 11, at 2.

<sup>43</sup> See SHAVELL, *supra* note 7, § 11, at 2.

Person	Value of Bridge to Each Person (\$)
1	10
2	20
3	30
4	40
5	50
6	60
7	70
8	80
9	90
10	100
Total Values	550

From society's perspective, this bridge should be built: the total value to our hypothetical society of ten users is \$550, whereas the total cost is only \$400. Construction of the bridge would improve social welfare by \$150.

However, let us further assume that the private supplier cannot differentiate between each type of person.<sup>44</sup> The high value users (individuals six through ten) do not look any different than the relatively low value users (individuals one through five), so the monopolist can charge only one price—the same price—to all potential users. She asks herself, how can I maximize my revenues if I build this bridge? If she charges a price of \$10, all ten people will pay it and use the bridge. The private monopolist will make \$100 minus her total costs of \$400. If she charges \$20, now person number one will not pay the price (because \$20 exceeds her value from using the bridge), but persons two through ten will pay the price. Private revenues will equal: nine users x \$20 each = \$180. The private producer continues with this calculation until she maximizes revenues. In this example, it turns out that the revenue maximizing price is \$60, only persons six through ten will find it worthwhile to pay it based on their respective utilities, and total revenue would equal \$300 (far lower than the \$550 total value available to all potential users of the bridge).

The common sense moral of this oversimplified example is that private revenues at monopoly price fall short of the *total* utility that is possible to all potential users.<sup>45</sup> Because the private supplier charges one price to maximize profit and cannot discriminate between different individuals with varying utility levels, some users who value the bridge at greater than its \$0 marginal cost but less than the monopoly price of \$60 (persons one through five) are prevented from using it.<sup>46</sup> This restriction of access creates a deadweight loss to society

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<sup>44</sup> See *id.* § 11, at 2 n.3.

<sup>45</sup> See *id.* § 11, at 2–3.

<sup>46</sup> See *id.*

because these “priced-out” potential users would have derived benefits greater than the costs that they would have imposed.<sup>47</sup> The private supplier is unable to capture all of their value, however, if she can only charge one price to all.<sup>48</sup>

### c. *Decreased Social Welfare Due to Restriction of Use*

Moreover, private supply suffers from the reality that even if charging a fee and preventing unauthorized use is possible, and even if private revenues exceed the development cost, society would still witness decreased overall welfare from private provision.<sup>49</sup> Any effort to prevent unpaid-for use (i.e., tollbooth construction and employees to operate them) is socially wasteful.<sup>50</sup> Furthermore, the amount of use of the product will be restricted to below that which is optimal due to the fact that the price charged is necessarily above zero.<sup>51</sup> Whenever price exceeds marginal cost, some would-be users are prevented from obtaining access to the good even though they value it more highly than the producer’s incremental cost.

### d. *Externalities*

Finally, private supply will not take into account any negative externalities inflicted upon non-users.<sup>52</sup> For example, in controlling access to a privately built bridge, firms would seek to set price to maximize profits, and not worry about the impact to the surrounding neighborhood of the pollution emitted by the cars that pass over. Conversely, one might imagine a government provider setting fees in some situations to discourage excess traffic and accompanying pollutants, aside from the issue of what value users *privately* receive. In essence, the government presumably will (or at least should) take into account all benefits and all costs that construction and access to public goods would impose on all members of society.

On the flip side, private supply cannot adequately take into account the positive externalities that public goods produce either. For example, preservation of a national park like Yellowstone may not only provide immediate value to users, but might also yield long-run benefits to society at large. Our citizens will become educated and acquainted with their natural surroundings, and even non-

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<sup>47</sup> *See id.*

<sup>48</sup> Note, if the private bridge builder could perfectly price discriminate between all types of potential users, then this problem of private supply would be eliminated. She could charge \$10 to the lowest value user all the way up to \$100 for the highest value user, and thus the restriction-of-use dilemma would be solved.

<sup>49</sup> *See SHAVELL, supra note 7, § 11, at 2–3.*

<sup>50</sup> *See id.*

<sup>51</sup> *See supra* Part II.A.2.b.

<sup>52</sup> *See GRAMLICH, supra note 37, at 18–20* (discussing externalities as a basis for government intervention in the private market).

users might reap “existence value” from simply knowing that certain land is preserved for posterity.<sup>53</sup> A private provider would be unable to capture that value in setting fees that only users pay, but the state could take these positive externalities into consideration when deciding whether or not to construct such public goods.<sup>54</sup>

Hence, if roads, bridges or parks were solely privately provided in America, it is reasonable to assume that supply and access would be greatly reduced compared to the status quo. Substantial costs would be incurred to restrict their use and to collect the necessary fees, too few roads and parks in total would exist, and it would be quite expensive to provide for numerous points of entry and exit into the system.<sup>55</sup> Such a situation is clearly not socially optimal.

Given these problems, government provision of certain goods is often required. The reality in America today reinforces the arguments in favor of public supply: the great majority of roads are publicly provided and use is generally free.<sup>56</sup> That is not to say that there are no problems associated with state supply; indeed there are.<sup>57</sup> The government, of course, needs to raise revenue to construct these goods. That entails raising taxes, and with any tax comes associated administrative costs to run the collection system and unintended distortions of work effort.<sup>58</sup> Second, the state confronts an information problem in deciding whether or not to build roads or parks in the first place.<sup>59</sup> Namely, how can the government gather enough data to accurately value proposed property development ex-ante and its accompanying cost of construction.<sup>60</sup> Conversely,

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<sup>53</sup> See John V. Krutilla, *Conservation Reconsidered*, 57 AM. ECON. REV. 777, 779 (1967) (introducing the notion of “existence values”—that is, even without using the good in question, individuals derive pleasure from simply knowing that it exists). *But cf.* Paul Milgrom, *Is Sympathy an Economic Value? Philosophy, Economics, and the Contingent Valuation Method*, in CONTINGENT VALUATION: A CRITICAL ASSESSMENT 417 (J.A. Hausman ed., 1993) (a skeptical assessment of the concept of existence value).

<sup>54</sup> *But cf.* MILTON FRIEDMAN, CAPITALISM AND FREEDOM 31 (1962) (claiming that national parks such as Yellowstone or the Grand Canyon could be provided by the private sector, just as amusement parks like Disneyland are).

<sup>55</sup> See SHAVELL, *supra* note 7, § 11, at 5–6.

<sup>56</sup> Note, where marginal cost is not equal to zero, the state should charge a fee for use rather than providing the public good freely. *See id.* at 7–8.

<sup>57</sup> See SILBERBERG, *supra* note 6, at 284 (noting that when public goods are provided for free, it is impossible to ascertain how much consumers truly value them).

<sup>58</sup> See SHAVELL, *supra* note 7, § 11, at 3; *cf.* Louis Kaplow, *The Optimal Supply of Public Goods and the Distortionary Cost of Taxation*, 49 NAT’L TAX J. 513, 514 (1996) (discussing the distortionary effect of taxes on individual decision-making, but noting that it is theoretically possible to raise tax revenues for public property without impacting work effort).

<sup>59</sup> See SHAVELL, *supra* note 7, § 11, at 3 (noting the difficulties states face in eliciting data on individual preferences).

<sup>60</sup> To calculate social value, the government might poll individuals to determine their willingness to pay for certain public goods. Such a survey mechanism is known as “contingent



the market supplies that answer in a private provision scheme. Because firms are forced to charge for use, whether or not people are actually willing to pay the price for the good provides an obvious market barometer of its value.<sup>61</sup> Furthermore, it is not always desirable to allow free use of public property<sup>62</sup>—often, marginal costs are slightly above zero because one person's use detracts from or absorbs another's use.<sup>63</sup> It is in these cases that even public providers should charge a fee to reflect the incremental costs that each user imposes on others.<sup>64</sup>

In the aggregate, however, there is no serious question that public provision of property is often necessary and required to maximize social welfare. The relevant question is how can the state get its hands on the property it needs?

### B. *Why Can't the Government Simply Purchase the Land It Needs?*

Collectively, we have realized that public ownership and provision of certain goods is indeed superior to private supply. Given that reality, the state needs a way to obtain the land on which to build these roads, bridges and parks. One might naturally inquire, however: why can't the state simply purchase the land outright from the individual property owners who hold it? Why should a land taking be forced against the consent of an unwilling property owner? After all, our entire body of contract law is premised on the voluntary nature of exchange: the common wisdom is that there are no contracts by compulsion.<sup>65</sup> Similarly, the

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valuation"—values that individuals report are contingent in that they are hypothetical: they are what people say they are willing to pay, not what they actually do spend. See ROBERT C. MITCHELL & RICHARD T. CARSON, *USING SURVEYS TO VALUE PUBLIC GOODS: THE CONTINGENT VALUATION METHOD 2* (1989); see also *CONTINGENT VALUATION: A CRITICAL ASSESSMENT*, *supra* note 53.

<sup>61</sup> See SILBERBERG, *supra* note 6, at 284 (noting that when goods are publicly provided and price equals zero, it becomes impossible to determine how much consumers value the good).

<sup>62</sup> See SHAVELL, *supra* note 7, § 11, at 7–8.

<sup>63</sup> For example, each car added to the roadway or bridge creates greater congestion, diminishing the enjoyment of other users.

<sup>64</sup> The desirability of charging a fee for access is especially strong where the administrative costs of excluding non-payers are low—that is, it may be relatively easy and inexpensive to erect a tollbooth at the entrance to a bridge, but quite difficult to do so around a lighthouse.

<sup>65</sup> See *Hurley v. Eddingfield*, 59 N.E. 1058 (Ind. 1901) (ruling physician not compelled to treat a dying patient even though he was perfectly able to do so); *Great Atl. & Pac. Tea Co. v. Cream of Wheat Co.*, 227 F. 46, 49 (2d Cir. 1915) (declaring that it is “part of a man's civil rights that he be at liberty to refuse business relations with any person whomsoever, whether the refusal rests upon reason, or is the result of whim, caprice, prejudice, or malice”). The rule regarding racially motivated refusals to contract has certainly been modified in the last century, but the holdings of these courts reflect the aversion that individuals have to government interference in contract and property relationships.

government could negotiate a mutually agreeable price with the landowner for the sale of her property to the state, and we would all feel better knowing that nothing was taken against the will of either of the parties.

The Coase Theorem would support this rendition of the desirable state of affairs.<sup>66</sup> The argument goes as follows: if the gain to the public (whose interests are represented by the government) from building a highway exceeds the detriment to the landowners displaced, there should be a mutually beneficial bargain struck. The government could buy up the private land for the value that the owners placed on it individually, and there would still be benefit left over to society. In this manner, overall social welfare would be enhanced without leaving the distaste caused by a forced transfer of property from private individuals to the state.

However, the reality is that bargaining frequently fails to produce the outcome described above.<sup>67</sup> As Ugo Mattei and William Strange separately note, there are several pitfalls that infect the bargaining process: most notably, administrative and transaction costs, the endowment effect, the holdout problem, and imperfect information.<sup>68</sup>

### 1. *Administrative Costs, Transaction Costs, and the Endowment Effect*

The administrative and transaction costs associated with bargaining in the land transfer context would be far from trivial.<sup>69</sup> Usually, many landowners will be involved, making it difficult for the state to negotiate collectively with all of them.<sup>70</sup> If parties are also located physically far apart, their ability to come together to form a mutually agreeable bargain is diminished.<sup>71</sup> In addition, owners might subjectively value their land more highly than that which the state

<sup>66</sup> See R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960) (asserting that parties will bargain to reach the optimal result so long as transaction costs are zero, rendering the initial assignment of entitlements irrelevant to the ultimate allocation of resources).

<sup>67</sup> See, e.g., Richard D. McKelvey & Talbot Page, *An Experimental Study of the Effect of Private Information in the Coase Theorem*, 3 EXPERIMENTAL ECON. 187 (2000).

<sup>68</sup> See UGO MATTEI, *COMPARATIVE LAW & ECONOMICS* 129 (2000) (suggesting that transaction costs and the holdout problem would make private supply of public goods virtually impossible); William C. Strange, *Information, Holdouts, and Land Assembly*, 38 J. URB. ECON. 317 (1994); see also Douglas W. Allen, *What are Transaction Costs?*, in 14 *RESEARCH IN LAW & ECONOMICS* 1 (Richard O. Zerbo, Jr. & Victor P. Goldberg eds., 1991).

<sup>69</sup> See generally Luca Anderlini & Leonardo Felli, *Costly Bargaining and Renegotiation*, 69 *ECONOMETRICA* 377 (2001) (discussing the inefficiencies that arise when negotiation between two parties takes place in the presence of transaction costs); see also SHAVELL, *supra* note 7, § 11, at 11–12.

<sup>70</sup> See SHAVELL, *supra* note 7, § 11, at 11–12.

<sup>71</sup> See *id.* § 10, at 8.

is willing to pay in terms of its fair market value.<sup>72</sup> The “endowment effect” enters into this negotiation process: when a party possesses a legal right (to keep her land for instance), she often insists on a much higher price to sell it than that which she would be willing to pay herself if she were asked to buy it.<sup>73</sup> This phenomenon—that the “willingness to accept” amount greatly exceeds one’s “willingness to pay” for the same piece of property—has been the subject of numerous economic studies and continues to play out in a variety of settings, not merely the land purchase context.<sup>74</sup> The consequence of this psychological power play is that a mutually agreeable price may never be found. Owners may refuse to sell under *any* terms, citing their “principled” right to retain their property.<sup>75</sup> After all, anything else would be un-American.

## 2. *The Holdout Problem*

Moreover, even if the great majority of landowners reached a price at which they were willing to voluntarily sell their property to the state, the government would still confront the “holdout problem.”<sup>76</sup> This dilemma stems from the fact that the state may need to buy multiple small properties, all of which are essential for full development of a single large scale public project. However, public knowledge of this fact puts the government at a severe disadvantage when it steps up to the negotiating table.<sup>77</sup> Let us imagine all homeowners but one have agreed

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<sup>72</sup> See *id.* § 11, at 11.

<sup>73</sup> See DUPONT & LEE, *supra* note 9, at 1–2 (attempting to explain the endowment effect and status quo bias). Moreover, Knetsch and Borchering have argued that the “offer-ask disparity” justifies providing government compensation greater than fair market value. See Jack L. Knetsch & Thomas E. Borchering, *Expropriation of Private Property and the Basis for Compensation*, 29 U. TORONTO L.J. 237, 240–42 (1979). However, Fischel responds that reimbursing displaced landowners beyond fair market value would negatively impact social welfare because it would necessarily reduce the number of public works possible in a world of limited resources. See William A. Fischel, *The Offer/Ask Disparity and Just Compensation for Takings: A Constitutional Choice Perspective*, 15 INT’L REV. L. & ECON. 187, 193 (1995).

<sup>74</sup> For example, in a famous experiment conducted in a Cornell economics class, half of the student subjects were given coffee mugs and allowed to trade them with their colleagues for cash at a later time. Because the initial assignments were random, the Coase theorem would predict that half of those mugs would change hands in order to find their way to those who valued them most highly. However, only fifteen percent of students actually traded their mugs. More tellingly, those with a mug asked more than two times as much to give up their mug as those without a mug offered to pay to obtain one. See Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1483–84 (1998).

<sup>75</sup> See SHAVELL, *supra* note 7, § 11, at 11.

<sup>76</sup> See LLOYD COHEN, 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 236–40 (Peter Newman ed. 1998) (discussing the holdout problem in the context of land acquisition); see also Strange, *supra* note 68 (same).

<sup>77</sup> See, e.g., SILBERBERG, *supra* note 6, at 288 (describing the classic “hold-up maneuver” if existing homeowners discover the developer’s plan, causing them to ask for exorbitant sums

to give up their land for specified compensation in order for the state to construct a highway. The remaining homeowner, who lives in the middle of the desired transportation path, would be able to exact an extremely high price for the sale of her property because of the great leverage she now enjoys. If she alone holds out, the state is effectively prevented from going forward with the project—even after it has spent substantial resources to acquire nearly all of the land necessary. Assuming that the landowner knows this, she will have every incentive to say: “I know my property is worth only \$100,000. But this highway is worth hundreds of millions and perhaps billions of dollars in value to the public. I won’t give up my land unless the state pays me \$1 million.” This unfortunate tactic would be a very real possibility if land could be acquired only through the bargaining process.<sup>78</sup>

### 3. Imperfect Information

Finally, information problems might negatively impact the possibility of privately negotiated bargains over property.<sup>79</sup> The government may not know precisely the true value of land to property owners, and may not believe the owner when she presents subjective evidence as to her asking price. Conversely, the private property owner may overestimate the value of her land in its proposed

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of money to sell their land). *But cf.* Patricia Munch, *An Economic Analysis of Eminent Domain*, 84 J. POL. ECON. 473 (1976). Munch questions the contention that the government could not purchase the necessary land, finding in her RAND Corporation study that the power of eminent domain is not more efficient than the market at consolidating parcels of property for major public works. *Id.* at 495.

<sup>78</sup> Given the reality of the holdout problem, one might wonder how private firms ever succeed in purchasing the land they need to construct grand shopping centers and other large-scale commercial developments. These projects often require negotiation with numerous individual landowners who hold small sections of the property that the developer will eventually need to proceed. Private companies frequently deal with the potential holdout problem by creating various facades behind which they can hide. Rather than disclose their large commercial construction plans and negotiate with all the landowners openly, they hire many different individuals or property management companies to approach each landowner separately. The property owners never become suspicious that a large scale project is in the works, and therefore, do not attempt to exact an artificially inflated price from the buyers. Many wealthy corporations and developers acquire the property they need in this manner, including Paul Allen (who purchased large tracts of land at the base of Lake Union in Seattle), and even Harvard University (which secretly bought up land in Allston that is now being proposed as the site of a new mega-graduate school complex). See Lewis Rice, *Cambridge v. Allston*, HARV. L. BULL., Summer 2002, [http://www.law.harvard.edu/alumni/bulletin/2002/summer/feature\\_1-fulltext.html](http://www.law.harvard.edu/alumni/bulletin/2002/summer/feature_1-fulltext.html) (last visited Apr. 13, 2003). When Boston mayor Thomas Menino criticized Harvard for the buying of land surreptitiously through a property management company, the school responded that “the use of an intermediary is a common practice in real estate deals for large institutions or municipalities.” *Id.*

<sup>79</sup> See generally SILBERBERG, *supra* note 6, at 384 (describing the pitfalls presented by asymmetric information in the bargaining process).

public use, and insist on a price above what she would be willing to accept because she incorrectly thinks that the state will be willing to pay it. There may be situations where a mutually agreeable price does in fact exist, but the parties' asymmetrical information causes them to think a bargain is impossible. In the end, no agreement may be reached even though both sides would have been better off.

All of these pitfalls in the bargaining process lead to the inevitable conclusion that voluntary exchange is not the most dependable way for the state to acquire the property it needs. So, that leaves the question: how can our government provide the public goods that society desires?

### C. *The Solution: Eminent Domain*

Given the shortfalls of private supply and the problems of state bargaining with landowners for the purchase of their property, the government needs a more efficient and effective way to obtain the land on which to build the public goods we all desire. The answer: its power of eminent domain. If the state wants your land, it can get it.

Eminent domain refers to the state's ability to commandeer private land for the "public use."<sup>80</sup> It should be made clear that this power includes and involves a *forced* taking—it does not matter if the landowner wishes to sell her property to the state or desires to give it up so that the public good can be served. The landowner has no choice. Property scholars Cunningham, Stoebuck and Whitman opine that this ability to take land without consent has become "universally accepted . . . as an inherent power of the federal and state governments, a necessary attribute of sovereignty."<sup>81</sup> The classic Supreme Court decision laying out this principle is *Kohl v. United States*,<sup>82</sup> where the Court gave its approval to the involuntary transfer of a parcel of land to the city of Cincinnati in order to

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<sup>80</sup> See William B. Stoebuck, *A General Theory of Eminent Domain*, 47 WASH. L. REV. 553, 557–61 (1972) (laying out a cohesive theory of eminent domain law).

<sup>81</sup> ROGER A. CUNNINGHAM ET AL., *THE LAW OF PROPERTY* § 9.1, at 506 (2d ed. 1993); see also Stoebuck, *supra* note 80, at 560 (questioning whether government would collapse if it had to bargain in the marketplace for land). While the government's power of eminent domain is now conceded, that does not imply that forced transfers of land from private owners to the state are non-controversial. Quite to the contrary, there is considerable popular aversion to government interference with private property ownership. This resistance has at its roots the notion that property ownership involves one's natural rights and personhood—any interference by the government with one's entitlement to property is unsettling. This "rights-based" strain of property ownership is the subject of numerous articles and editorials, and is beyond the scope of this paper. See generally RICHARD TUCK, *NATURAL RIGHTS THEORIES: THEIR ORIGIN AND DEVELOPMENT* 6–32 (1995).

<sup>82</sup> 91 U.S. 367 (1875).

build a post office.<sup>83</sup> Similar decisions followed in *United States v. Jones*,<sup>84</sup> *Cairo and Fulton Railroad Co. v. Turner*,<sup>85</sup> and *Sinnickson v. Johnson*.<sup>86</sup>

It is interesting, however, that the Constitution does not bestow this right of eminent domain, but rather *limits* it by requiring that the government pay for what it takes.<sup>87</sup> The Fifth Amendment explicitly states “. . . nor shall private property be taken for *public use* without *just compensation*.”<sup>88</sup> While this provision does not apply directly to individual states, it has long been accepted that the due process clause of the Fourteenth Amendment imposes this minimum federal guarantee on the states as well.<sup>89</sup> Further, forty-seven state constitutions now expressly prohibit the taking of private property for public use without just compensation, and the others have been construed to include the same prohibition.<sup>90</sup> Two issues immediately jump to the forefront. First, what is “public use?” Is this an absolute limitation on the ability to take land? Second, what is “just compensation?” How is it determined and why should the state pay it?

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<sup>83</sup> *See id.* at 374.

<sup>84</sup> 109 U.S. 513 (1883) (holding that the right of eminent domain is inherent in sovereignty, and exists without recognition by the Constitution).

<sup>85</sup> 31 Ark. 494 (1876) (holding that a taking of land for railroad purposes is a legitimate exercise of the power of eminent domain even if the railroad is a private corporation). However, of course compensation shall be made for such a taking.

<sup>86</sup> 17 N.J.L. 129 (N.J. 1839) (denying relief in an action to recover damages for the overflow of a body of meadow land, caused by the erection of a dam by the defendants across Salem Creek). For a detailed history of takings law, see FRED BOSSELMAN ET AL., *THE TAKING ISSUE: AN ANALYSIS OF THE CONSTITUTIONAL LIMITS OF LAND USE CONTROL* 82–104 (1973).

<sup>87</sup> *See* U.S. CONST. amend. V.

<sup>88</sup> *Id.* (emphasis added).

<sup>89</sup> *See* STOEBUCK & WHITMAN, *supra* note 3, § 9.2, at 521, § 9.4, at 525; *see also* Chi., Burlington & Quincy R.R. Co. v. City of Chicago, 166 U.S. 226 (1897). While later cases discuss “incorporation” of the Fifth Amendment’s Takings Clause into the Fourteenth Amendment’s Due Process Clause, the *Chicago, Burlington & Quincy Railroad* case does not use an incorporation rationale. Rather, the Court stated that substantive due process requires payment of just compensation whenever private property is taken for public use. *See* CUNNINGHAM ET AL., *supra* note 81, § 9.1, at 506 (citing JOHN E. NOWAK ET AL., *CONSTITUTIONAL LAW* 412–15 (1978)).

<sup>90</sup> *See* CUNNINGHAM ET AL., *supra* note 81, § 9.1, at 506; *see also* PHILIP NICHOLS, *THE LAW OF EMINENT DOMAIN* § 1.3, at 1-97 to 1-102 (3d ed., J. Sackman rev. ed. 1979). The three states lacking such constitutional provisions are Kansas, North Carolina and Virginia. The forty-seven states with constitutional clauses prohibiting takings without compensation are modeled on the language of the federal Constitution. Additionally, twenty-six of these states require state reimbursement for property that is not merely “taken,” but which is “damaged.” This proviso aids in the recovery of payment for several non-trespassory interferences with private property, aside from instances of physical takings. *See* CUNNINGHAM ET AL., *supra* note 81, § 9.1, at 506.

### 1. "Public Use": An Absolute Limitation on the Takings Power?

A careful reader of the Fifth Amendment will notice that it states "private property shall not be taken *for public use* without just compensation."<sup>91</sup> It does not state that private property can be taken *only* for public use. Nevertheless, constitutional scholars and historians such as Hugo Grotius have long argued that the government's power of eminent domain is more limited than the use of its other powers.<sup>92</sup> An extreme interpretation of the Constitution would hold that property can *never* be taken for anything other than public use; however, it is clear this view is rarely applied by courts.<sup>93</sup> Rather, the words "public use" have come to be regarded as imposing some constraint on the government's ability to take land, although Thomas Merrill and James Durham independently note that the restriction has been moderated beyond what many lay observers think.<sup>94</sup>

The leading Supreme Court case on the subject is *Berman v. Parker*.<sup>95</sup> The question presented was whether the District of Columbia had the power to condemn land for urban renewal where the land was to be reconveyed to *private* developers to complete the project.<sup>96</sup> After all, how can a government land taking be for public use if a private firm is the party who winds up owning the land? The Court responded to this challenge by construing public use to mean "public purpose"<sup>97</sup>—that is, even if private parties are involved in the construction project, it may still be public purpose they are accomplishing (clearing slums and removing urban blight under the facts of *Berman*<sup>98</sup>). Governmental power to accomplish these ends exists in its general police powers—and eminent domain serves as an auxiliary power in that regard.<sup>99</sup> Thus, the public use limitation can

<sup>91</sup> U.S. CONST. amend. V (emphasis added).

<sup>92</sup> HUGO GROTIUS, *DE JURE BELLI AC PACIS* 385 (F. Kelsey transl. 1925); CORNELIS VAN BYNKERSHOEK, *QUAESTIONUM JURIS PUBLICI* 218 (T. Frank transl. 1930); see also Stoebuck, *supra* note 80, at 588–99; Comment, *The Public Use Limitation on Eminent Domain: An Advance Requiem*, 58 *YALE L.J.* 599 (1949); *Bloodgood v. Mohawk & Hudson River R.R.*, 18 *Wend.* 9, 57–58 (N.Y. 1837) (holding that although a New York statute authorizing the taking of private property for public improvements such as railroads was constitutional, a railroad was not entitled to take and appropriate the plaintiff's land until damages were appraised and compensation paid).

<sup>93</sup> See STOEBUCK & WHITMAN, *supra* note 3, §§ 9.2–9.4, at 518–38.

<sup>94</sup> See Thomas Merrill, *The Economics of Public Use*, 72 *CORNELL L. REV.* 61, 61 (1986) (stating that in practice, "most observers today think the public use limitation is a dead letter"); see also James Geoffrey Durham, *Efficient Just Compensation as a Limit on Eminent Domain*, 69 *MINN. L. REV.* 1277, 1278 (1985).

<sup>95</sup> 348 U.S. 26 (1954).

<sup>96</sup> *Id.* at 33–34.

<sup>97</sup> *Id.*

<sup>98</sup> *Id.* at 28.

<sup>99</sup> *Id.* at 32–34.

more accurately be viewed as requiring that the state have some public purpose.<sup>100</sup>

Subsequent decisions have reinforced this line of thinking, and have broadened the public purpose prong considerably. In *Poletown Neighborhood Council v. City of Detroit*,<sup>101</sup> the Michigan Supreme Court gave its approval to the use of eminent domain by Detroit to obtain a large area of land it then intended to convey to General Motors Corporation for use as an assembly plant.<sup>102</sup> Again, the challenge arose: how can private land be taken against the will of an owner to serve the coffers of a corporation? The court held that the test of constitutionality was whether the proposed taking was for “the primary benefit of the public or the private user.”<sup>103</sup> Reasoning that the land at stake was needed to serve the crucial public purpose of alleviating unemployment and revitalizing the local economy, a public purpose was indeed found.<sup>104</sup> The benefit to the private corporation was “merely incidental.”<sup>105</sup> Thus, the government can, except in a few states, take land and assign it to a private company as long as some public goal is met. In fact, states have routinely delegated the power of eminent domain not only to local counties and municipal corporations, but also to private companies such as railroads and utilities, as long as they provide some service to the public.<sup>106</sup>

The public purpose requirement was expanded yet again in *Hawaii Housing Authority v. Midkiff*.<sup>107</sup> *Midkiff* involved a challenge to a Hawaii statute

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<sup>100</sup> There is some dissent from this “public purpose” concept among *state* courts interpreting their own *state* constitutions. Washington is one such state, though consistency in its decisions has proven elusive. For instance, the Washington Supreme Court refused to allow Seattle to condemn land at Westlake Center to be leased to private stores, but upheld eminent domain actions to support private urban renewal in Tacoma. *Compare In re City of Seattle (In re Westlake Project)*, 638 P.2d 549, 559–60 (Wash. 1981), with *Miller v. City of Tacoma*, 378 P.2d 464, 475 (Wash. 1963). The courts in *In re Westlake* and earlier in *Hogue v. Port of Seattle*, 341 P.2d 171 (Wash. 1959), purported to literally apply the words “for public use,” requiring that the land condemned be physically used by the public. *City of Seattle*, 638 P.2d at 556–56; *Hogue*, 341 P.2d at 189. However, the decision in *Tacoma*—where urban renewal condemnations allowed land to be resold to private developers for private business or residential use—obviously runs afoul of such a literal interpretation of “public use.” See *Tacoma*, 341 P.2d at 470–71.

<sup>101</sup> 304 N.W.2d 455 (Mich. 1981).

<sup>102</sup> *Id.* at 457.

<sup>103</sup> *Id.* at 458.

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 459.

<sup>106</sup> See, e.g., *Bloodgood v. Mohawk & Hudson River R.R.*, 18 Wend. 9 (N.Y. 1837).

<sup>107</sup> 467 U.S. 229 (1984). *Midkiff* made the “sale-to-private-users” issue much clearer than did *Berman*—while resale to private urban developers was a large part of the *Berman* case, the greater question was whether any city might condemn land for projects that were “nice but not necessary.” *Id.* at 239–43.



authorizing the state to take fee simple title from owner-lessors and transfer it to lessees in order to reduce the concentration of fee simple ownership on the island.<sup>108</sup> The Supreme Court relied on *Berman* and its progeny in holding:

The mere fact that property taken outright by eminent domain is transferred . . . to private beneficiaries does not condemn that taking as having only a private purpose. . . . The Hawaii legislature enacted its Land Reform Act not to benefit a particular class of identifiable individuals but to attack certain perceived evils of concentrated property ownership in Hawaii—a legitimate public purpose.<sup>109</sup>

Hence, the issue of public use is quite likely to be found in the state's favor when it attempts to exercise its power of eminent domain today. As long as some public purpose is served by the government's action, courts will generally support the takings power.

## 2. "Just Compensation": What Is It, and Why Should the State Pay It?

Once the state satisfies the public use requirement in an eminent domain action, it must still reimburse the displaced landowner by providing her "just compensation" for her property.<sup>110</sup> Usually, eminent domain cases are not about whether the government had a legitimate public purpose in making its decision, but rather, how much the condemnee should receive.<sup>111</sup>

While the amount of just compensation is an issue for the jury to decide, the most fundamental principle of takings law is that it should equal the fair market value of one's property and be paid in cash.<sup>112</sup> Leading cases on the subject

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<sup>108</sup> *Id.* at 232–33.

<sup>109</sup> *Id.* at 243–45. I should note that this case was a uniquely Hawaiian phenomenon. The Hawaii Legislature had found that almost one-half of the state's land was owned by the state and federal governments; that another 47% was in the hands of *only 72 private owners*; and that the 18 largest landowners (all holding tracts of 21,000 plus acres) held more than 40% of the 47% of all land held privately. *Id.* at 232.

<sup>110</sup> U.S. CONST. amend V.

<sup>111</sup> See STOEBUCK & WHITMAN, *supra* note 3, § 9.5, at 539–45. Since *Turner v. County of Del Norte*, 101 Cal. Rptr. 93 (Cal. Ct. App. 1972), and especially since *San Diego Gas & Electric v. City of San Diego*, 450 U.S. 621 (1981), most eminent domain litigation questions and scholarship have centered around the specifics of the compensation amount, many of which the Supreme Court has not yet answered. STOEBUCK & WHITMAN, *supra* note 3, § 9.5, at 539–45. Such difficulties include the measure that should be used to calculate the compensation due for a temporary taking, whether it is constitutionally permissible to deduct from an owner's loss the value of offsetting benefits that the governmental entity might offer the owner, and what specific degree of loss is required before a taking occurs in the first place. *Id.*

<sup>112</sup> See, e.g., *United States v. 50 Acres of Land*, 469 U.S. 24, 25–26 (1984) (holding that condemnee is not entitled to compensation measured by the cost of acquiring a substitute facility in the case where fair market value of the condemned property is ascertainable). For a detailed analysis of the calculation of compensation in condemnation proceedings, see

include *Shoemaker v. United States*,<sup>113</sup> *Riley v. District of Columbia Redevelopment Plan*,<sup>114</sup> and *Vanhorne's Lessee v. Dorrance*.<sup>115</sup> *Shoemaker* involved the calculation of just compensation for the taking of land to construct Rock Creek Park in Maryland,<sup>116</sup> and *Riley* concerned the proper reimbursement for a condemnation of a home.<sup>117</sup> *Vanhorne's Lessee*, one of the most caustic decisions in all of eminent domain law, highlighted the problem of how to fairly compensate an aggrieved landowner when there is no market for the property that the condemnee owned.<sup>118</sup> The overarching principle behind all of these opinions is that the state must provide the aggrieved landowner the just and fair amount of money—that is, the fair market value—that their property was worth at the time of the taking.<sup>119</sup>

In cases where only part of an owner's property is taken, she is entitled to the reasonable value of the lost land, plus any "severance damages" suffered by the remaining part as well.<sup>120</sup> This allowance reflects the reality that the project for which the taking is made might interfere with the neighboring land that remains, thus reducing its value.<sup>121</sup> It also recognizes that when the two parts of a given piece of land can no longer be utilized together, the value of the portion kept will frequently decline.

But, *why* should the state be forced to pay just compensation when it takes land? Even if there were no constitutional mandate, the prevailing wisdom is that the principles of fairness and justice dictate that the deprived landowner be reimbursed for the fair market value of that which was taken away from her. In

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CURRENT CONDEMNATION LAW: TAKINGS, COMPENSATION & BENEFITS (Alan T. Ackerman ed., 1994).

<sup>113</sup> 147 U.S. 282 (1893).

<sup>114</sup> 246 F.2d 641 (D.C. Cir. 1957).

<sup>115</sup> 2 U.S. (2 Dall.) 304 (1795).

<sup>116</sup> *Shoemaker*, 147 U.S. at 296–98.

<sup>117</sup> *Riley*, 246 F.2d at 642–43.

<sup>118</sup> *Vanhorne's Lessee*, 2 U.S. (2 Dall.) at 310–16.

<sup>119</sup> However, many scholars dispute whether or not this "fair market value" principle is indeed borne out by reality. Munch argues that depending on the court costs of buyers and sellers, prices paid under eminent domain may systematically differ from the fair market value standard. Munch, *supra* note 77, at 488. Her study indicated that when high-value land is taken, owners often receive more than fair market value, whereas when low-value property is taken, owners usually obtain less than fair market value. *Id.* at 495. Other critics charge that fair market value should not be the guiding principle behind government reimbursement because it is not enough to adequately compensate aggrieved landowners who subjectively value their property more highly than that of the market. Further, the systematically low estimates of fair market value may bias feasibility judgments and lead to inefficient resource allocations. See Jack L. Knetsch, *The Endowment Effect and Evidence of Nonreversible Indifference Curves*, 79 AM. ECON. REV. 1277–84 (1989).

<sup>120</sup> See CUNNINGHAM ET AL., *supra* note 81, § 9.1, at 512.

<sup>121</sup> See *id.*

this manner, the homeowner is left no worse off than she was initially (assuming money perfectly compensates for lost memories and subjective valuations<sup>122</sup>), and the public as a whole is better off. Economists would call this a *Pareto optimal* result<sup>123</sup>: no one is made worse off because the homeowner receives the monetary equivalent of her property, and at least one person (society) is made better off. Moreover, the hope and intention is that this taking will ideally increase the welfare of everyone. All citizens are presumably better off having a well-developed and well thought-out transportation and recreational infrastructure, and no one is truly left aggrieved. The power of eminent domain—accompanied by just compensation—thus allows us to achieve a solution that is both fair and improves overall social welfare.<sup>124</sup>

In addition to the principled fairness-based justification for compensation, legal scholars have traditionally defended the requirement by arguing that mandatory government reimbursement insures risk averse individuals against the unpleasant chance of eminent domain stripping them of their property value.<sup>125</sup> One might imagine that if the state were allowed to commandeer land without paying for it, homeowners might reasonably worry that the government could take away their house without warning, leaving them with nothing—a rather unsettling thought. At least when one knows she will receive the fair market value of her property should this unlikely but upsetting event occur, the sting is somewhat mitigated.

A third justification for state-provided reimbursement is that by requiring compensation, the government will only take land when it is in the public's best

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<sup>122</sup> *But cf.* Knetsch & Borcharding, *supra* note 73, at 244–48 (arguing that the subjective valuation problem, coupled with the endowment effect, mitigates in favor of paying just compensation above fair market value in order to make landowners equally well off). While this approach has some psychological appeal, requiring the state to pay more money than the land is actually worth necessarily reduces the number of beneficial public works in which it can engage. *See* Fischel, *supra* note 73, at 187–93.

<sup>123</sup> *See* JOSEPH E. STIGLITZ, *PRINCIPLES OF MICROECONOMICS* 320 (2d ed. 1997) (defining Pareto improvements as “changes that make some better off without making anyone worse off”).

<sup>124</sup> *Cf.* LOUIS KAPLOW & STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* (2002). The fairness-based argument offered above is a version of the classical conception of corrective justice: “it’s only fair that if the government harms me, that it should compensate me.” Kaplow and Shavell argue that such notions of fairness and corrective justice ought to have zero independent weight in social decisions. Rather, laws should be designed to maximize efficiency, and then the tax system can be used to achieve the fairness and distributive justice goals that society desires.

<sup>125</sup> *But cf.* SHAVELL, *supra* note 7, § 11, at 13–14 (debunking the risk-aversion defense of government-provided just compensation, and arguing that private takings insurance would serve the same function of guarding against unwanted exposure to risk).

interest to do so.<sup>126</sup> Some have argued that if the reimbursement provision were removed from the Constitution, the government would take private land too frequently—simply because it would be free.<sup>127</sup> Property scholar Peter Menell thus sees the Fifth Amendment's requirement of just compensation as "an important constraint on government decision-making" and abuse.<sup>128</sup> When payment of just compensation is imposed by the Constitution, there is a disincentive for the state to excessively procure private land, because if it does so without a legitimate public purpose it will be forced to pay monetary compensation without yielding any accompanying benefit to its citizens. Since citizens do not like to see their tax dollars wasted, the requirement of government reimbursement will minimize the state's desire to take land indiscriminately.

I will argue later that these traditional justifications for government-paid just compensation miss the mark to some extent.<sup>129</sup> If fair reimbursement to landowners and the protection against risk are society's goals, private takings insurance may be able to accomplish them just as well as government reimbursement can.<sup>130</sup> Moreover, while the potential for government abuse of

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<sup>126</sup> See William Fischel & Perry Shapiro, *Takings, Insurance and Michelman: Comments on Economic Interpretations of 'Just Compensation' Law*, 17 J. LEGAL STUD. 269, 269–70 (1988) (stating that "[t]he compensation requirement . . . disciplin[es] the power of the state, which would otherwise overexpand unless made to pay for the resources that it consumes").

<sup>127</sup> See *id.* Public choice literature lends credibility to this claim, as government actors may be swayed by powerful interest groups to excessively take property if payment were not required. See generally DWYER & MENELL, *supra* note 28, at 893–95 (citing to public choice theorists Hayes, McCormick and Tollison, Wilson, Salisbury, Buchanan, and Tullock for the proposition that legislators respond more directly to small group lobbyists than to the overall public good).

<sup>128</sup> E-mail from Peter S. Menell, Professor of Property Law at U.C. Berkeley, Boalt Hall School of Law (received Dec. 10, 2002) (on file with author) (commenting that the takings insurance alternative to state-based reimbursement may reflect an overly optimistic view of government decision-making, and that the contributions of the public choice literature have enabled him to view the Takings Clause of the Constitution as an important constraint on public decision-making). Property law scholar Bill Stoebuck echoes the concern that state-based compensation is needed to reign in government power, arguing that payment was required of the English Parliament and of American governmental entities as an explicit restraint on state power stemming from our fundamental distrust of government. Letter from William B. Stoebuck, Professor of Property Law at the University of Washington, School of Law (Jan. 7, 2003) (on file with author).

<sup>129</sup> See *infra* Parts III.C, III.D.

<sup>130</sup> See SHAVELL, *supra* note 7, § 11, at 13–14. While many initially perceive it to be "unfair" to require landowners to purchase private insurance to reimburse themselves for the taking of their *own* property by the state, they are already paying "public insurance" today in the form of their income taxes that go to fund "just compensation" payouts in the event of eminent domain actions. Theoretically, the increase in insurance premiums would be offset by a corresponding decrease in taxes. It is possible, of course, that the net outlay of dollars spent by individual landowners would increase, perhaps because income taxes currently paid by non-landowners under today's system are partially subsidizing the funding of government payouts

eminent domain in the absence of a just compensation requirement is a legitimate concern, it may not be as severe as initially thought due to inherent conservatism bias among public bureaucrats.<sup>131</sup> Finally, the principled fairness-based rationale offered above fails to explain the dichotomy in today's Supreme Court jurisprudence between physical takings of land versus regulatory takings—victims of the former receive mandatory state reimbursement; the latter often do not—despite the fact that both often suffer similar financial loss.

#### *D. Physical Versus Regulatory Takings: The Tortured Evolution of Regulatory Takings Caselaw*

Traditionally, takings of land were just that—*physical* takings of one's property. However, governments are increasingly attempting to control land use not by actually occupying property, but by promulgating regulations designed to affect the uses to which the land can be put. Such regulatory takings are sometimes called “inverse condemnations,” as the landowner involved seeks a judicial ruling that the government action in question has effectively “gone so far as to assert a de facto public use of [their] property to the exclusion of most, if not all, private uses.”<sup>132</sup>

The federal government's power to regulate land use in this manner is based on the various express power delegations in the U.S. Constitution.<sup>133</sup> The states' ability to do the same is derived from their inherent powers, as ratified by the Tenth Amendment.<sup>134</sup> States often delegate these powers to local governmental units, such as counties or even small towns.<sup>135</sup> For instance, a municipality may pass a zoning ordinance in response to citizen demand that certain property be designated “residential only”—that is, no commercial development allowed. Other federal regulations forbid all construction entirely, perhaps to preserve a natural wetland for posterity.<sup>136</sup> Unfortunately, in so doing, the property owner's

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of just compensation to displaced property owners. One might respond that even if this is the case, requiring property owners to bear a larger portion of the compensation funding is fair, since after all, they are the parties eligible to receive this compensation. In any event, there is certain to be great debate over the net financial effect of switching to private takings insurance. *See infra*, Parts III.B–D.

<sup>131</sup> *See infra* Part III.D.3.

<sup>132</sup> Gerald Torres, *Wetlands and Agriculture: Environmental Regulation and the Limits of Private Property*, 34 U. KAN. L. REV. 539, 555 n.93 (1986).

<sup>133</sup> *See* STOEBUCK & WHITMAN, *supra* note 3, § 9.2, at 519.

<sup>134</sup> U.S. CONST. amend X; *see also* STOEBUCK & WHITMAN, *supra* note 3, § 9.2, at 519.

<sup>135</sup> *See* STOEBUCK & WHITMAN, *supra* note 3, § 9.2, at 519–20.

<sup>136</sup> For example, “sensitive area restrictions,” such as wetlands, shorelands, and greenbelt ordinances, may severely restrict or prohibit the development of parcels of land that happen to be in the areas they protect. *See id.* § 9.1, at 518. Moreover, the federal government plays a crucial role in the protection of water quality and wetlands under authority of the Federal Water

prior expectations for the opportunities presented by her land may be quashed. The burning question is whether these regulatory takings that diminish the use, enjoyment or investment value of property will be compensated for in the same way that physical takings always have been.<sup>137</sup>

Despite the growing incidence of regulatory takings, the early days of eminent domain jurisprudence focused primarily on physical land takings.<sup>138</sup> The boundaries of public use and just compensation were delineated by the courts, and the law became relatively predictable in that context. As regulatory takings came into the fold, the judiciary was faced with a unique challenge.<sup>139</sup> On the one hand, the property owner had a legitimate interest in preserving the investment value of her property and doing with it what she chose.<sup>140</sup> On the other, states had a valid police power interest in regulating certain land uses so as to promote the overall public health, safety and welfare.<sup>141</sup> However, what should become of the

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Pollution Control Act Amendments of 1972, which were supplemented by the Clean Water Act of 1977 and the Water Quality Act of 1987. *See id.* § 9.34, at 699. While landowners protest, Joseph Sax points out that these regulations are often justified, as it is naive to suppose that the consequences of a property user's activities are limited to her property alone. *See Joseph L. Sax, Takings, Private Property and Public Rights*, 81 YALE L.J. 149, 152 (1971).

<sup>137</sup> Several scholars have attempted to tackle the tricky problem of compensation for regulatory takings. Farber contends that regulatory takings should receive compensation only when they are the "functional equivalent" of physical takings. *See Daniel Farber, Public Choice and Just Compensation*, 9 CONST. COMMENT. 279, 280 (1992). Epstein has written a provocative book asking whether takings can be justified without just compensation under the government's police powers. *See RICHARD A. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN* (1985). Sax explores the difficulty in distinguishing between takings in the constitutional sense (which require reimbursement) versus the legitimate exercise of police power (which does not demand compensation). *See Sax, supra* note 136, at 149–51. Finally, Blume and Rubinfeld engage in a thorough economic analysis of compensation for takings, highlighting its difficulties in the regulatory context. *See Lawrence Blume & Daniel L. Rubinfeld, Compensation for Takings: An Economic Analysis*, 72 CAL. L. REV. 569 (1984).

<sup>138</sup> Some of the early seminal decisions include: *Kohl v. United States*, 91 U.S. 367 (1875); *United States v. Jones*, 109 U.S. 513 (1883); *Bonaparte v. Camden & Amboy Railroad Co.*, 3 F. Cas. 821 (C.C.D.N.J. 1830) (No. 1617); and *Cairo & Fulton Railroad Co. v. Turner*, 31 Ark. 494 (1876). *See supra* notes 82–86.

<sup>139</sup> *See Lawrence Berger, A Policy Analysis of the Taking Problem*, 49 N.Y.U. L. REV. 165 (1974) (detailing the difficulty in determining the point at which government regulations achieve sufficient magnitude such that courts will deem them a "taking," and so require just compensation); *see also Sax, supra* note 136, at 149–51 (discussing the problems inherent in distinguishing between regulatory takings that require compensation versus valid exercises of state police power which do not); Blume & Rubinfeld, *supra* note 137, at 570 (dealing with the challenge of compensation for regulatory takings).

<sup>140</sup> *See Fischel & Shapiro, supra* note 126, at 269 (stating that without compensation, private investment in land would be seriously inhibited by the thought that the government will snatch the fruits of one's labor).

<sup>141</sup> For instance, state bodies often can see certain negative externalities (such as pollution) emanating from one owner's use of her land, and regulate appropriate uses

affected landowner—should she be left holding the bag without reimbursement simply because no *physical* invasion of her land occurred?<sup>142</sup>

Unfortunately, courts facing this predicament struggled with the issue of when the legitimate exercise of police power reached far enough so as to be deemed a constitutional “taking” requiring government compensation.<sup>143</sup> The Supreme Court itself has been unable to develop a consistent and predictable standard in this regard.<sup>144</sup> *Mugler v. Kansas*<sup>145</sup> was the first foray into this judicial minefield. The plaintiff, Peter Mugler, owned a building that he converted into a brewery and which was useful only for that purpose.<sup>146</sup> Sadly for him, Kansas passed a statute prohibiting the production of alcohol.<sup>147</sup> The Supreme Court, faced with the question of whether such a regulatory action warranted compensation under the Constitution, decisively held in the negative: “a prohibition simply upon the use of property for purposes that are declared, by valid legislation, to be injurious to the health, morals, or safety of the community, cannot, in any just sense, be deemed a taking or an appropriation of property.”<sup>148</sup>

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accordingly. See GRAMLICH, *supra* note 37, at 18–20; see also *Vill. of Euclid v. Ambler Realty Co.*, 272 U.S. 365, 395 (1926) (local zoning ordinance was valid exercise of police power unless “clearly arbitrary and unreasonable, having no substantial relation to the public health, safety, morals, or general welfare”). One should note that scholars such as Joseph Sax have focused on the divide between state exercises of police power (which generally do not demand compensation to affected individuals), versus regulations that rise to the level of constitutional takings (hence requiring reimbursement). See Sax, *supra* note 136, at 149–51.

<sup>142</sup> Until the Supreme Court’s decision in *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393 (1922), physical invasion was necessary for government action to be considered a taking requiring just compensation. *Id.* at 415–16.

<sup>143</sup> See CUNNINGHAM ET AL., *supra* note 81, § 9.2, at 512–13. As mentioned above, the power of the U.S. government to regulate land use is expressly restricted by the Due Process and Takings Clauses of the Fifth Amendment. Moreover, although the Fourteenth Amendment lacks an express takings clause, its due process clause makes the takings clause of the Fifth Amendment applicable to the states as well. See, e.g., *Chi., Burlington & Quincy R.R. v. City of Chicago*, 166 U.S. 226, 235 (1897). Hence, both the federal and state governments must comply with due process requirements when engaging in regulatory takings, and substantive due process challenges have long been brought against such actions.

<sup>144</sup> See, e.g., *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 123–24 (1978) (Supreme Court admitting that the question of what constitutes a “taking” for purposes of the Fifth Amendment has proven to be “a problem of considerable difficulty,” and that the Court has been “unable to develop any ‘set formula’ for determining when ‘justice and fairness’ ” require government compensation); see also STOEBUCK & WHITMAN, *supra* note 3, § 9.4, at 527–38.

<sup>145</sup> 123 U.S. 623 (1887).

<sup>146</sup> See *id.* at 657.

<sup>147</sup> See *id.* at 655.

<sup>148</sup> *Id.* at 668–69. This outcome makes intuitive sense, as it would seem strange to offer compensation to individuals who were engaging in actions that the legislature has deemed so harmful as to deserve absolute prohibition.

*Mugler* thus struck the first blow in favor of the state's absolute police power: where land is regulated to serve the public's health, morality or safety, it is not a constitutional taking requiring any compensation.<sup>149</sup>

A few years later, in *Lawton v. Steele*,<sup>150</sup> the Supreme Court confronted an analogous New York law that authorized state seizure and destruction of illegal private fishing nets.<sup>151</sup> In finding that no compensation was due to the impacted owners, the Court promulgated what has long been considered the classic balancing test for "substantive due process" in regulatory takings jurisprudence.<sup>152</sup> To determine whether a regulatory action is a valid exercise of police power under the Fourteenth Amendment (hence, not requiring reimbursement), courts should consider "first, [whether] the interests of the public . . . require such interference; and second, that the means are reasonably necessary for the accomplishment of the purpose, and [third,] not unduly oppressive upon individuals."<sup>153</sup> This due process "oppression" test sensibly balanced the importance of the state's public purpose with the reasonableness of the means used and the impact on affected property owners. Unfortunately, the *Lawton* Court failed to provide guidance as to the relative weight of the designated factors, injecting some uncertainty into their future application.<sup>154</sup>

*Reinman v. City of Little Rock*<sup>155</sup> and *Hadacheck v. Sebastian*<sup>156</sup> were the next important regulatory takings cases decided by the Court, and illustrate its sudden return to the *Mugler* test of validity of state police power at the expense of considering "undue landowner oppression" arguments.<sup>157</sup> Despite the strong endorsement of states' police power in *Reinman* and *Hadacheck*, the Court

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<sup>149</sup> The *Mugler* Court applied a substantive due process test, but found that the Fourteenth Amendment's Due Process Clause was not designed to obstruct the states' police power, which could not be "burdened with the condition that the State must compensate . . . individual owners of property for pecuniary losses they may sustain [because of regulatory takings]." *See id.* at 669.

<sup>150</sup> 152 U.S. 133 (1894).

<sup>151</sup> *See id.* at 135.

<sup>152</sup> *Id.* at 137.

<sup>153</sup> *Id.*

<sup>154</sup> *See* CUNNINGHAM ET AL., *supra* note 81, § 9.2, at 514.

<sup>155</sup> 237 U.S. 171 (1915).

<sup>156</sup> 239 U.S. 394 (1915).

<sup>157</sup> In upholding an ordinance prohibiting the operation of livery stables in downtown Little Rock, the *Reinman* Court stated that the only constitutional limitation on the police power of the states is that it cannot be exercised arbitrarily or with unjust discrimination. *See Reinman*, 237 U.S. at 176. Similarly, in *Hadacheck*, the Court upheld a Los Angeles ordinance prohibiting the manufacture of bricks in a designated part of the city where Mr. Hadacheck owned a brick factory. The Court ruled that "the imperative necessity for [the state's police power] precludes any limitation upon it when not exerted arbitrarily." *See Hadacheck*, 239 U.S. at 410.



reversed its philosophy in *Pennsylvania Coal v. Mahon*,<sup>158</sup> reverting to balancing the public interest against that of landowner oppression. The Court famously stated, “the general rule . . . is that while property may be regulated to a certain extent, if [a] regulation goes *too far* it will be recognized as a taking.”<sup>159</sup>

The Supreme Court altered its course again in *Village of Euclid v. Ambler Realty Co.*,<sup>160</sup> ignoring property owner oppression arguments in sustaining a new zoning technique for regulating urban land uses against a substantive due process challenge.<sup>161</sup> Indeed, from the late 1930s to the 1950s, the Court seemed to have abandoned substantive due process considerations entirely: it was clear that any regulatory action would be upheld as a valid exercise of the state police power unless it was exerted arbitrarily or discriminatorily.<sup>162</sup>

That approach changed with the Supreme Court’s decision in *Penn Central Transportation v. City of New York*.<sup>163</sup> There, the Court adopted the prior *Mahon* oppression test, promulgating three factors to be balanced in determining whether a regulation amounted to a constitutional taking requiring compensation. The court is to weigh: (1) the character of the government action; (2) the extent to which it interferes with investment expectations; and (3) the economic impact on the claimant.<sup>164</sup> Further, the Court held that an exercise of police power is valid only where it allows a remaining “reasonable beneficial use” of the property affected.<sup>165</sup> However, Justice Brennan’s majority opinion left the standards to be applied in regulatory takings cases as confused as ever, applying substantive due process, equal protection and a separate “taking” analysis for good measure.<sup>166</sup> The Court went so far as to admit the terrible difficulty it had experienced in finding any “set formula” for determining when justice and fairness require government compensation for regulatory takings.<sup>167</sup>

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<sup>158</sup> 260 U.S. 393 (1922).

<sup>159</sup> 260 U.S. at 415–416 (emphasis added). One should note, though, that *Keystone Bituminous Coal Ass’n v. De Benedictis*, 480 U.S. 470 (1987), appears to have been decided inconsistently with *Mahon*. The *Keystone* Court upheld a Pennsylvania statute strikingly similar to the Kohler Act struck down in *Mahon*. *Keystone*, 480 U.S. at 506. It seemed to adopt two of the principal arguments that Justice Brandeis asserted in his *Mahon* dissent: (1) that if the Court is “to consider the value of the coal kept in place by the [statutory] restriction” the Court should compare that value with “the value of all other parts of the land,” and (2) that an owner’s rights against the public are not increased by dividing the interests in his property into surface subsoil. *Mahon*, 260 U.S. at 419.

<sup>160</sup> 272 U.S. 365 (1926).

<sup>161</sup> *See id.* at 390.

<sup>162</sup> *See* CUNNINGHAM ET AL., *supra* note 81, at 518.

<sup>163</sup> 438 U.S. 104 (1978).

<sup>164</sup> *See id.* at 124.

<sup>165</sup> *See id.* at 138.

<sup>166</sup> *See id.* at 107–15.

<sup>167</sup> *See id.* at 123–24.

*Nollan v. California Coastal Commission*<sup>168</sup> strengthened the *Penn Central* test, holding that an “essential nexus” between the government’s purpose and the means selected to achieve that goal could only be met if the regulation “substantially advances . . . a legitimate state interest.”<sup>169</sup> Hence, where a state committee imposed a condition requiring a private property owner to donate an easement in order to obtain a building permit, there was a constitutional taking requiring that compensation be provided.<sup>170</sup> *San Diego Gas & Electric Co.*<sup>171</sup> and *First English Evangelical Lutheran Church*<sup>172</sup> further indicated the Supreme Court’s growing willingness to exact compensatory relief for state regulatory actions, with the latter case expressly holding that the Fifth Amendment mandated payment of just compensation for regulatory takings.<sup>173</sup> It did not, however, deal with important questions for making the determination in the first place.

Recognizing the continued uncertainty over whether state and city regulatory actions required government compensation, the Supreme Court attempted to settle the matter once and for all in its landmark 1992 decision, *Lucas v. South Carolina Coastal Council*.<sup>174</sup> In confronting litigation over an environmental ban on coastal development in South Carolina, the *Lucas* Court breached the doctrinal wall between physical and regulatory takings. In a triumph for the conservative wing of the bench, the majority rejected Court precedents calling for a case-by-case balancing of the government’s interests against the owner’s legitimate expectations.<sup>175</sup> Rather, the Court held that a land use regulation that deprives a property owner of “all economically beneficial or productive use of land” (even

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<sup>168</sup> 483 U.S. 825 (1987).

<sup>169</sup> *See id.* at 834, 837.

<sup>170</sup> *See id.* at 838–39.

<sup>171</sup> *San Diego Gas & Elec. Co. v. City of San Diego*, 450 U.S. 621 (1981) (dismissing the *San Diego Gas* appeal on procedural grounds, but in doing so four members by dissent and one more by concurrence argued that compensation is mandated by the Fifth Amendment where the merits dictate it). *See id.* at 633–61.

<sup>172</sup> *First English Evangelical Lutheran Church v. County of Los Angeles*, 482 U.S. 304 (1987).

<sup>173</sup> The *First English* Court held that where a challenged regulation equated a *de facto* taking, the local governing body could elect either to keep it in force via its power of eminent domain or to acquiesce by invalidating the regulation. By choosing the latter, it would be required to pay just compensation for the time period that the invalid regulation was in force. *See id.* at 321.

<sup>174</sup> 505 U.S. 1003 (1992).

<sup>175</sup> *Cf. Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978) (laying out a three-factor balancing test for whether or not a given government regulatory action amounted to a constitutional taking requiring compensation); *see also* Linda Greenhouse, *Justices Weaken Movement Backing Property Rights*, N.Y. TIMES, Apr. 24, 2002, at A1 (discussing the rejection of prior Court precedents in favor of the *Lucas* “deprivation of all economically beneficial use” rule, which itself was drastically reformulated last year in the *Tahoe* case).

though she remains in possession) is a categorical taking requiring state compensation.<sup>176</sup> Thus, regardless of the state interest involved or the means used, the government must reimburse an aggrieved landowner for the diminution in value it causes anytime a regulation destroys substantially all property value.<sup>177</sup>

Despite the Court's quest for resolution, the regulatory compensation issue did not end there. Last year, in *Tahoe-Sierra Preservation Council v. Tahoe Regional Planning Agency*,<sup>178</sup> the Supreme Court dramatically adjusted its regulatory takings jurisprudence. In *Tahoe*, the Court faced the question of whether a thirty-two month moratorium on development passed by the Tahoe Regional Planning Agency amounted to a categorical land use taking that demanded compensation in fairness to the affected owners.<sup>179</sup> One might naturally think that a nearly three-year prohibition on all development would be an easy case following on the heels of *Lucas*—there is no question that substantially all economic value was stripped from the land. However, the Court stepped back from its prior takings jurisprudence, stating that this ban on construction did *not* qualify as a de facto taking of property.<sup>180</sup> In so doing, the Court revitalized the divide between physical and regulatory takings, restricting compensation to exceptional circumstances in the regulatory context.<sup>181</sup> Justice Stevens, writing for the majority, relegated the *Lucas* decision to “the extraordinary case in which a regulation *permanently* deprives property of *all* value.”<sup>182</sup>

The proffered reasoning seemed to be that the development moratorium in *Tahoe* lasted “only” thirty-two months,<sup>183</sup> even though some landowners were not allowed to build even *after* the temporary prohibition ended. True, at the expiration of the ban, property holders were able to recover some or most of the economic value of their land. However, the moratorium did cause substantial economic loss (estimated to be \$27 million by the impacted landowners), and as Chief Justice Rehnquist pointed out in dissent, the Constitution purportedly “requires that the costs and burdens [of regulatory takings] be borne by the public at large, not by a few targeted citizens.”<sup>184</sup> Moreover, the logic surrounding the

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<sup>176</sup> See *Lucas*, 505 U.S. at 1015–16.

<sup>177</sup> See *id.*

<sup>178</sup> 535 U.S. 302 (2002).

<sup>179</sup> See *id.* at 330–33. The Tahoe Regional Planning Agency passed this moratorium in order to study the effects of new land development before it would offer building permits to property owners.

<sup>180</sup> See *id.* at 333–38.

<sup>181</sup> See *id.*

<sup>182</sup> *Id.* at 332 (emphasis added).

<sup>183</sup> See *id.* at 340–42 (concluding that such temporary moratoria do not amount to categorical takings, and that they might even increase land values during the period of time that development is prohibited).

<sup>184</sup> *Tahoe*, 535 U.S. at 354 (Rehnquist, C.J., dissenting).

“permanency” (or lack thereof) of the regulation is inconsistent with that of *Lucas* and with prior Court jurisprudence. In *Lucas*, the South Carolina Coastal Council could have similarly decided to reverse its ban on coastline development sometime in the future—and could still do so today for that matter. In fact, the *Lucas* Court expressly held that even though the state may elect to rescind a regulation at some later date, “where the [regulation has] already worked a taking of all use of property, no subsequent action by the government can relieve it of its duty to provide compensation for the period during which the taking was effective.”<sup>185</sup> The *Tahoe* holding regarding the “temporary” thirty-two month nature of the development moratorium seems irreconcilable with this position. In truth, *Tahoe* marked a fundamental shift in American takings jurisprudence: the chasm between compensation for physical versus regulatory takings has widened substantially.<sup>186</sup> The question then is: *why?*

### E. Why Not Require Compensation for All Regulatory Takings?

Given the *Lucas* decision, one might have thought that the reimbursement question was settled in the fairest way possible: if the regulation’s effect is so significant that it destroys virtually all land value, then the owner is entitled to compensation.<sup>187</sup> But, why should an owner receive nothing when faced with a regulatory action that fails to meet this “categorical taking” threshold?<sup>188</sup> Shouldn’t she be entitled to reimbursement for *any* reduction in fair market value attributed to government regulation? Now that *Tahoe* has been decided by the

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<sup>185</sup> See *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1030 n.17 (1992) (citing *First English*, 482 U.S. at 321 (1987)).

<sup>186</sup> Patrick Parenteau, professor of environmental law at Vermont Law School, commented that the *Tahoe* ruling “breaks with a 15-year Supreme Court trend of favoring individual property rights over government aims.” Anne Gearan, *Limits on Tahoe Growth Upheld*, SEATTLE POST-INTELLIGENCER, Apr. 24, 2002, at 3. This may be justified, however, as a “ruling for the landowners would have tied the hands of local officials faced with growth and development that outpace anyone’s ability to gauge the environmental effects.” *Id.* Conversely, Chip Mellor, President of the Institute for Justice, argues that the *Tahoe* decision “will make it more difficult for individuals to hold governments accountable when they strategically and unjustifiably use procedural maneuvers to prevent people from building homes on property that is rightfully theirs.” *Id.* Thus, it does not appear that the Supreme Court has ended the debate over how to deal with regulatory takings just yet.

<sup>187</sup> See *Lucas*, 505 U.S. at 1015–16.

<sup>188</sup> Michelman addressed this issue as well, asking why should the government compensate for some but not all losses due to its actions. See Frank I. Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of ‘Just Compensation’ Law*, 80 HARV. L. REV. 1165, 1165–66 (1967); see also Thomas J. Miceli & Kathleen Segerson, *Regulatory Takings: When Should Compensation be Paid?*, 23 J. LEGAL STUD. 749 (1994).

Supreme Court, staunch property rights advocates are reeling.<sup>189</sup> The requirement that the state pay just compensation for regulatory takings has been dramatically weakened, yet the Court was unable to articulate a compelling fairness-based rationale for the differential treatment.

In this context, economic theory provides some explanation for the determination of whether compensation is desirable for physical versus regulatory takings.<sup>190</sup> The simple answer to the newly pronounced dichotomy is that while many would prefer to compensate for any proven decrease in property value due to regulatory actions, it is practically impossible to do so.<sup>191</sup> The state and local governments act in hundreds of ways each year that affect land use values, from the decision of what zoning ordinances to pass to where to build public schools, prisons, libraries, roads or parks. Separating out positive from negative effects, and compensating for every action, is simply infeasible.<sup>192</sup> Endless litigation would ensue, rendering the eminent domain system a battlefield and grinding the activities of the state to a halt.<sup>193</sup> From this practical perspective, the *Tahoe* limitation that a regulation must amount to a categorical taking that *permanently* deprives the landowner of substantially all the economic value of her land makes some common sense.<sup>194</sup> It separates out regulatory takings that forever destroy the owner's legitimate investment expectations for her land, and recognizes the pragmatic difficulties in compensating for all state regulatory actions.

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<sup>189</sup> See Gearan, *supra* note 186 (noting that the ruling comes as a major disappointment to conservative activists, who had hoped the case would further the cause of private property rights).

<sup>190</sup> See Michelman, *supra* note 188, at 1165–72 (addressing why the government compensates for some but not all losses resulting from takings, and concluding that the line drawn diverges from considerations of utility or fairness); Farber, *supra* note 137, at 287–99 (exploring public choice theory and whether or not regulatory takings should receive just compensation); EPSTEIN, *supra* note 137 (arguing that some takings can be justified without reimbursement under the state's police power); Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 513–14 (1986) (finding that just compensation is not defensible on the grounds of upholding investment incentives or allocating risk); Sax, *supra* note 136, at 149–55 (offering a new notion of property rights to help explain the distinction between regulatory takings that require compensation versus exercises of police power which do not); Berger, *supra* note 139, at 195 (suggesting a “first in time” approach would be most fair and efficient for determining the point at which government regulations reach sufficient magnitude to constitute a “taking” and so require compensation); Thomas S. Ulen, *Still Hazy After All These Years*, 22 LAW & SOC. INQUIRY 1011 (1997) (discussing the great controversy surrounding compensation for regulatory takings).

<sup>191</sup> See *Tahoe*, 535 U.S. at 323–25 (2002) (detailing the practical difficulties in treating physical and regulatory takings in the same manner).

<sup>192</sup> See *id.*

<sup>193</sup> See *id.*

<sup>194</sup> See *id.*

Thus, perhaps the most legitimate justification for the current split between physical and regulatory takings jurisprudence is continuing concern over the workability of providing *any* compensation at all in the regulatory arena.<sup>195</sup> Justice Stevens was perturbed by this very dilemma, presenting the functional economic argument for differential treatment of the two categories of land takings. He opined:

Land use regulations are ubiquitous and most of them impact property values in some tangential way—often in completely unanticipated ways. Treating them all as *per se* takings would transform government regulation into a luxury few governments could afford. By contrast, physical appropriations are relatively rare, easily identified, and usually represent a greater affront to individual property rights.<sup>196</sup>

However, this answer cannot be entirely satisfactory to the fairness/corrective justice theorists—if a landowner could indisputably prove that a portion of her land value was directly destroyed by a moratorium on development, why should she be undeserving of compensation? Justice Stevens' argument is primarily concerned about the uncertainty surrounding the regulatory situation; surely there are scenarios (like those of *Lucas* and *Tahoe*) where there is no question that a regulatory taking has deprived the owner of virtually all of the value of her land in direct contravention to her legitimate ex-ante investment expectations.<sup>197</sup> Thus, the principle of fairness cannot be the governing rationale behind the divide between physical and regulatory takings doctrine. Rather, economic theory and the ability to practically make the necessary valuation determinations are driving current Supreme Court jurisprudence.

Unfortunately, no permanent resolution to the debate appears imminent. Property law scholars Cunningham, Stoebuck, and Whitman have noted that the problem of what to do about compensating for government regulations is “perhaps the most burning legal question that today surrounds the growing number of land-use regulations. A satisfactory answer has eluded our courts, especially the United States Supreme Court, for a hundred years.”<sup>198</sup> And it will continue to do so long after *Tahoe*.

The most pressing question then is not what takings law *is*, but what the law *should be* with respect to the issue of compensation for invasions of both the

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<sup>195</sup> See *id.*

<sup>196</sup> See *id.* at 324.

<sup>197</sup> For a fuller treatment of the economic incentives and expectations surrounding regulatory takings, see THOMAS J. MICELI & KATHLEEN SEGERSON, COMPENSATION FOR REGULATORY TAKINGS: AN ECONOMIC ANALYSIS WITH APPLICATIONS § 4, at 47–65 (1996) (comparing and contrasting landowner versus regulator incentives).

<sup>198</sup> CUNNINGHAM ET AL., *supra* note 81, at 509 (though the authors made this observation on the heels of *Lucas* in 1993, it appears as true as ever today).

physical and regulatory variety. How can we improve our current eminent domain and just compensation system? Part III argues that the traditional justifications for requiring state-paid just compensation are off base, and that society would be better served by the emergence of a private insurance market in lieu of government reimbursement. While takings insurance may work well in the physical land procurement context, an insurance scheme may prove impractical in the regulatory arena. If that is true though, the explanation for the differential treatment of physical and regulatory takings is functional in nature; fairness would be an unlikely ground to rest on. While it may be more challenging to measure the decline in value attributable to regulatory actions, that does not imply it does not exist.

### III. ECONOMIC THEORY: WHAT SHOULD BE DONE ABOUT COMPENSATING FOR TAKINGS?

Several economists—Farber, Shavell, Kaplow, and many others—have explored whether the requirement of just compensation for any kind of eminent domain action should be eliminated.<sup>199</sup> This sounds like a radical idea at first, but I will argue that if state-based reimbursement is replaced with private takings insurance, landowners will be left no worse off and society will be made better off. First, Part III.A examines the traditional rationale given for the mandatory payment of compensation by the government to affected landowners. Part III.B analyzes the problems posed by this reimbursement requirement, focusing on the perverse incentives that guaranteed compensation gives property owners to excessively improve their land. As an alternative, Parts III.C and III.D detail the possibilities presented by utilizing private insurance coverage to reimburse landowners in lieu of state-paid compensation.<sup>200</sup> Replacing government reimbursement with takings insurance offers several advantages over today's eminent domain system, including reduced administrative and transaction costs, and better behavior-monitoring capabilities. Takings insurance presents drawbacks as well, most notably the risk that the government might take too

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<sup>199</sup> See Farber, *supra* note 137, at 280–87 (inquiring whether insurance might be an effective substitute for just compensation); SHAVELL, *supra* note 7, § 11, at 13–15; Kaplow, *supra* note 190, at 535 (discussing optimal government “transition” policy); see also Munch, *supra* note 77, at 473 (arguing that eminent domain with just compensation is not a more efficient institution than the free market for consolidating land); EPSTEIN, *supra* note 137, at 136–37 (exploring when takings may be justified without compensation); Michelman, *supra* note 188, at 1171–72 (asking whether just compensation need be provided for takings); Robert D. Cooter, *Unity in Tort, Contract and Property: The Model of Precaution*, 73 CAL. L. REV. 1, 21–22 (1985) (noting that one corner solution is for the government to provide no reimbursement at all for takings, but that this is not possible in today's society).

<sup>200</sup> For an extensive analysis of this subject, see generally Blume & Rubinfeld, *supra* note 137, at 590–92.

much land if it no longer must compensate for it. Finally, Part IV will address whether insurance could work as a practical solution with respect to regulatory takings. The drawbacks of insuring against regulatory risks will probably prevent its application,<sup>201</sup> but that does not imply that insurance could not function fairly effectively in the physical land takings context, nor does it suggest any fairness-based justification for the Supreme Court's differential treatment of physical and regulatory takings.

#### A. *Traditional Rationale for Government Payment of Just Compensation*

Historically, fundamental notions of natural rights, personhood, fairness and protection against risk exposure have justified the mandatory payment of compensation when the government takes land for the public use. Philosopher John Locke first articulated the idea that it is part of every person's natural rights to own property and enjoy the fruits of her labor<sup>202</sup>—one might reasonably infer that any attempt by the state to interfere with such a right should be heavily restricted. Margaret Radin has further explored notions of personhood intricately tied up with property ownership.<sup>203</sup> The premise underlying the personhood perspective is that to achieve proper self-development—that is, to be a person—an individual needs some control over resources in the external environment.<sup>204</sup> The necessary assurances of control take the form of property rights. Radin further argues that the personhood perspective is often implicit in the connections that courts and commentators find between property and privacy, or between property and liberty,<sup>205</sup> providing another reason to restrict government eminent domain powers by requiring mandatory compensation.

Reimbursement for deprivation of property also makes intuitive sense from a fairness and corrective justice perspective. As Fischel and Shapiro argue, why should the government be entitled to interfere with a landowner's reasonable investment expectations regarding her property without providing compensation

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<sup>201</sup> See *id.* at 594–96 (discussing potential insurance market failures due to moral hazard and adverse selection).

<sup>202</sup> See JOHN LOCKE, *SECOND TREATISE OF GOVERNMENT*, ch. V, § 34 (Macpherson ed. 1980) (discussing the fact that people have the right to own property and own the fruits of their labor).

<sup>203</sup> See Margaret Jane Radin, *Property and Personhood*, 34 *STAN. L. REV.* 957, 957 (1982) (exploring in detail the relationship between property and personhood). Philosopher Immanuel Kant explored the personhood argument centuries ago in the intellectual property rights context. See Immanuel Kant, *Of the Injustice of Counterfeiting Books*, in 1 *ESSAYS AND TREATISES ON MORAL, POLITICAL, AND VARIOUS PHILOSOPHICAL SUBJECTS* 225, 229–30 (W. Richardson trans., 1798).

<sup>204</sup> Radin, *supra* note 203, at 957.

<sup>205</sup> *Id.*



in return?<sup>206</sup> We all understand that the state sometimes needs to take land for the greater public good—the construction of roads, parks and libraries for instance—but it should not be allowed to do so without making the affected landowner whole, or at least as whole as money can make someone.<sup>207</sup> Not surprisingly, the Fifth Amendment's Due Process and Takings Clauses reflect this intuition, constraining the government's power of eminent domain to recognize the justice of mandatory reimbursement.<sup>208</sup> Public choice theorists would most likely agree with this position<sup>209</sup>—and view the constitutional requirement of just compensation as an important restriction on government decision-making and abuse of power.

Second, as Frank Michelman alluded to in his classic article on just compensation, government-provided reimbursement serves the purpose of

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<sup>206</sup> See Fischel & Shapiro, *supra* note 126, at 269 (noting that without just compensation for takings, private investment in property would be significantly inhibited); see also *Penn Cent. Transp. Co. v. City of New York*, 438 U.S. 104, 127 (1978) (holding that the severe frustration of distinct investment-backed expectations may amount to a taking of property). Kaplow also discusses the effect of government policy on the value of investments. See Kaplow, *supra* note 190, at 511–12.

<sup>207</sup> The implication that money can make one completely whole for deprivation of her property is offered rhetorically, as dollars are rarely a perfect substitute for the value that property owners attach to their land. Nevertheless, the principle behind government provision of just compensation is that payment of fair market value reimburses landowners for their loss as well as can be expected. A fuller explanation of the adequacy of dollars in exchange for property taken in eminent domain actions is beyond the scope of this paper. Knetsch and Borcharding have written on this issue, and argue that fair market value may not be enough to adequately compensate displaced landowners, due primarily to the endowment effect that one feels when already in possession of the property in question. See Knetsch & Borcharding, *supra* note 73, at 241–42.

<sup>208</sup> See U.S. CONST. amend. V. Constitutional historian William Jones believes that the Takings Clause is thus properly viewed as the Framers' method for "encouraging work, saving, and investment by providing security for the fruits of [one's] economic endeavors." See William K. Jones, *Confiscation: A Rationale of the Law of Takings*, 24 HOFSTRA L. REV. 1, 8 (1995). Philosopher John Locke would likely agree with this modern assessment, as he argued centuries ago for the imposition of strict limits on government interference with individual property rights in order to promote economic development, work, savings and investment. See LOCKE, *supra* note 202, at § 5.

<sup>209</sup> Public choice scholars challenge the notion of representative government as a rational process yielding legislation that serves our collective best interests. Rather, they raise legitimate concerns that powerful interest groups may capture government decision-makers, and produce government actions that inure to the benefit of a few to the detriment of many. See generally JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* (1962); MICHAEL T. HAYES, *LOBBYISTS AND LEGISLATORS: A THEORY OF POLITICAL MARKETS* (1981); ROBERT E. MCCORMICK & ROBERT D. TOLLISON, *POLITICIANS, LEGISLATION, AND THE ECONOMY: AN INQUIRY INTO THE INTEREST-GROUP THEORY OF GOVERNMENT* (1981); JAMES Q. WILSON, *POLITICAL ORGANIZATIONS* (1973); Robert H. Salisbury, *An Exchange Theory of Interest Groups*, 13 *MIDWEST J. POL. SCI.* 1 (1969).

insuring risk averse individuals against the unlikely but unpleasant chance that the state might decide to build an interstate through their front yard.<sup>210</sup> Imagine a small property owner with little wealth outside of her home and the land upon which it sits. If the government could simply remove her against her will because doing so served a greater public purpose, her entire life fortune could be wiped away in an instant. Such a risk is too great for most middle class or lower class individuals to bear, especially considering the importance and impact of risk aversion on their psyche.<sup>211</sup> Just knowing that one faced this potential burden would reduce her welfare immensely—Michelman refers to it as the “demoralization” cost of takings.<sup>212</sup> Conversely, when one is assured that the state must compensate for any taking it deems desirable, the impact of such action upon one’s welfare is substantially mitigated.<sup>213</sup>

Finally, rarely mentioned as a justification for just compensation (outside academic circles at least) is the incentive-based argument regarding the socially ideal *amount* of government takings.<sup>214</sup> Mandatory government reimbursement is defended on the ground that by forcing the state to pay for any taking it engages in, society has provided optimal incentives for the state to act—or not act.<sup>215</sup> It will only take a given piece of property if the overall social value once it is put to its public use exceeds that of its original fair market value. This is so because the government knows it must compensate the displaced property owners, and also is aware that citizens generally frown upon wastes of resources. It thus decides to take land if and only if it creates more value for the public than it must pay out (by disbursing tax revenue) to the aggrieved landowners.

<sup>210</sup> See Michelman, *supra* note 188, at 1214 (discussing “demoralization costs” as one ground for providing reimbursement for government takings).

<sup>211</sup> See generally COOTER & ULEN, *supra* note 25, at 46 (discussing the concept that diminishing marginal utility of income makes individuals risk-averse). It is thus reasonable to believe that individuals with less wealth at their disposal would be poorly situated to bear the risk of wealth-destroying eminent domain actions.

<sup>212</sup> See Michelman, *supra* note 188, at 1214–17. I note, however, that subsequent commentators have argued that the “demoralization” cost that Michelman referred to was not necessarily a reference to risk aversion, but rather, the special psychological trauma experienced by individuals whose property is confiscated by the state. See Farber, *supra* note 137, at 286 (citing Fischel & Shapiro, *supra* note 126, at 269).

<sup>213</sup> The principle of risk aversion is the underlying basis for the purchase of all forms of insurance in society. People on average would rather bear a small certain loss (insurance premiums) than face the risk of an uncertain adverse event materializing, and bearing all of its cost. See GUIDO CALABRESI, *THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS* 39 (1970); COOTER & ULEN, *supra* note 25, at 49.

<sup>214</sup> See, e.g., Farber, *supra* note 137, at 295–99; Kaplow, *supra* note 190, at 566–76.

<sup>215</sup> See Fischel & Shapiro, *supra* note 126, at 269–70 (“The compensation requirement serves the dual purpose of offering a substantial amount of protection to private entitlements, while disciplining the power of the state, which would otherwise over-expand unless made to pay for the resources it consumes.”).

Conversely, if the requirement of just compensation were abandoned, critics reasonably argue that the government would now have an excess incentive to take land for public purposes, even when the total value of the property in its public use is less than the value that its original owners placed on it.<sup>216</sup> If the state were relieved from its obligation to pay for taking land, there appears to be no fiscal check on its actions.<sup>217</sup> It may not carefully consider whether overall public welfare increases, because if it sees any potential use for the land, some gain will be realized and the loss to the displaced property owners falls solely upon their shoulders—not the government's. Further, government decision-makers might be tempted to misuse their new-found freedom, whereas the mandatory reimbursement required by the Fifth Amendment may serve as a vital constraint on government abuse.

While these justifications for the requirement of just compensation contain merit, they are primarily arguments for *some* form of compensation to be paid—but not necessarily *government-provided* compensation.<sup>218</sup> In Parts III.C and III.D, I will present the advantages and disadvantages of insurance-based compensation substituting for the government-based reimbursement that we take for granted today. First, however, we should consider the pitfalls presented by society's reliance on state-provided compensation to impacted landowners.

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<sup>216</sup> See *id.* See also Richard A. Epstein, *Symposium on Richard Epstein's Takings: Private Property and the Power of Eminent Domain: An Outline of Takings*, 41 U. MIAMI L. REV. 3, 12–14 (1986) (explaining that the allocation of benefits between private landowners and the general public when the government condemns property for a public use is difficult to measure, and that assigning a value to the property taken is similarly problematic, but “[n]o one says we should abandon the just compensation problem in its entirety”); Eric Kades, *Avoiding Takings “Accidents,” a Tort Perspective on Takings Law*, U. RICH. L. REV. 1235, 1256–61 (1994) (providing historical evidence that government does not always act in a way that maximizes the public welfare, and concluding that without the just compensation clause, government would sometimes take private property even when the value to the private landowner was greater than the value of the public use); Merrill, *supra* note 94, at 74–77 (explaining that without eminent domain, private landowners would be able to exert “monopoly” profits when the government needed to take property; i.e., because each parcel of land is unique, the private owner is the only person from whom the government can buy the land for its public use). This means that without eminent domain setting the sale price at fair market value, the cost of some takings would be greater than the public benefit, or some takings that occur with eminent domain would not occur in a world without it because the price would be too high. *Id.*

<sup>217</sup> See Fischel & Shapiro, *supra* note 126, at 269–70.

<sup>218</sup> See SHAVELL, *supra* note 7, § 11, at 13. The only argument that specifically militates in favor of state-based compensation (as opposed to insurance-based reimbursement) is that regarding the potential for government abuse of its eminent domain power once relieved of its financial obligation to pay for takings.

## B. *It's Not a Free Lunch: Drawbacks of Just Compensation*

The traditional rationale behind government payment of just compensation for takings has not been frequently tested, especially beyond academic circles. A responsible government must critically examine the problems created by mandatory state reimbursement, however, and consider ways to change the compensation mechanism for the benefit of all. While the requirement of just compensation seems difficult to argue with at first, it can lead to perverse incentives to invest excessively in land in certain situations, and inevitably creates substantial administrative and transaction costs in the takings and tax-generation contexts.

### 1. *Excess Incentives to Invest in Improving Land*

When the state provides reimbursement upon taking land, it unintentionally gives property owners an excess incentive to invest in improving their land. An example will help illustrate this problem. Let us imagine that the city of Seattle is considering the construction of a new light-rail public transportation system to alleviate traffic congestion on the I-5 corridor.<sup>219</sup> Let us also imagine this project has been discussed in the media for some time so that everyone is aware that it may happen, even though competing political agendas make its construction less than 100% certain. A proposed route has been outlined in the local newspapers so that landowners along it are aware they face potential displacement in the name of the greater public good.<sup>220</sup> Given the current political climate, it is a reasonable estimate that the project has a 50% chance of moving forward to completion. A landlord of an apartment building in its path is considering whether or not to proceed with a \$1 million renovation of her building, which she expects will yield her \$1.5 million in increased rents and market value of her property. What will she choose to do knowing that there is a 50% chance that even if she renovates, the improvements made will quickly be torn down in favor of light rail?

Under today's system of mandatory government payment of just compensation, the landlord's private calculus is simply to compare the \$1 million cost of renovation versus the expected \$1.5 million increase in property value from renovation. No adjustment is made for the risk that light rail may necessitate a demolition of her building, rendering her improvements a social waste—

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<sup>219</sup> This example is not a hypothetical one, as the city of Seattle and all of the Puget Sound region have been debating the introduction of a public transportation system for decades. See, e.g., *Monorails Never Get Stuck in Traffic*, July 11, 2002 (direct mail pamphlet to citizens of the Seattle area outlining the costs, benefits, and proposed route of a new monorail system) (on file with author).

<sup>220</sup> See *id.*; see also Eric Pryne, *Tukwila a Hitch in Light Rail Plan*, SEATTLE TIMES, May 31, 2002, at B1 (outlining a proposed route for light rail through the city of Tukwila, which objected vociferously to the location of the line).

because the landowner receives the enhanced fair market value of the property either way. If the city chooses to abandon the public transportation project or locate it elsewhere, the landlord nets the increased rents provided by her apartment building due to the improvements. Alternatively, if Seattle goes ahead with light rail and exercises its power of eminent domain over the property, it must pay out the renovated fair market value—equal to \$1.5 million. So, it is an easy decision from the landowner's private perspective: go forward with improvements to your land regardless of the chance that those improvements will be for naught.<sup>221</sup>

But, is the landlord's private decision to renovate optimal from *society's* perspective? Clearly not. 50% of the time there will be a net increase in social value of \$500,000 (i.e., when the renovations are made and no light rail system is built that would necessitate demolition). The other half of the time all of the \$1 million spent on improvements will be a social waste, because immediately after those resources are expended, the building is torn down. No one enjoys the increased value provided by the enhancements to the property, yet the state is forced to pay just compensation for them. On net, the expected value to society of the landowner's decision to make property improvements is:  $[50\% \times (\$1.5 \text{ million} - \$1 \text{ million})]^{222} - [50\% \times (-\$1 \text{ million})]^{223} = -\$250,000$ . Thus, society would prefer that the landowner not immediately improve her property because of the significant chance that the land will shortly be taken for other public purposes, and all of the expenses associated with the renovation will be wasted.<sup>224</sup>

The root of the excess improvement problem is that our government-based compensation structure reimburses the landowner for the value of her property either way. There is no "reasonableness" determination made regarding whether certain improvements were in the public's best interests given the risk of eminent

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<sup>221</sup> See SHAVELL, *supra* note 7, § 11, at 15–16.

<sup>222</sup> This half of the equation reflects the 50% of the time when the improvements are made and the building is not demolished. Hence, there would be an increase in social welfare of \$500,000.

<sup>223</sup> This half of the equation represents the other half of the time where the \$1 million is spent on improvements but wasted because they are torn down under the government's power of eminent domain.

<sup>224</sup> See SHAVELL, *supra* note 7, § 11, at 15–16. Numerous cases have come before courts where aggrieved landowners sought the full value of their land *with* all new improvements. *See, e.g.,* Div. of Bond Fin. of Dep't of Gen. Servs. v. Rainey, 275 So. 2d 551 (Fla. 1973) (awarding the value of land as enhanced by investments made immediately prior to filing of lawsuit); Saratoga Fire Prot. Dist. v. W.C. Hackett, 97 Cal. App. 4th 895 (2002) (holding that property owner should be allowed to establish the increase in value of his building in the year between filing of complaint and actual taking of property); J.L. Mathews, Inc. v. Md.-Nat'l Capital Park & Planning Comm'n, 792 A.2d 288, 309 (Md. 2002) (explaining that fair market value to be awarded includes improvements made to land); Town of Newington v. Estate of Young, 777 A.2d 219 (Conn. 2000) (holding that developer entitled to compensation for loss of crops on commandeered land).

domain.<sup>225</sup> Hence, mandatory payment of just compensation to property owners inevitably gives them excess incentives to make improvements to their land compared to the socially optimal incentive to do so. Not surprisingly, in cities like Tallahassee and Saratoga and Montgomery, millions of dollars of property investment have gone wasted after foreseeable eminent domain actions forced their demolition.<sup>226</sup>

Courts could attempt to mitigate the problem by imposing a “reasonableness of investment” standard before the landowner could be reimbursed for improvements.<sup>227</sup> However, such a legal approach would be largely unworkable given the uncertainty surrounding many public projects of this type.<sup>228</sup> How would a judge view a landowner who knew for ten years that a light rail project was being discussed, but where its contours were unclear and its future uncertain? It would be prohibitively difficult to make judgment calls about which improvements were reasonable and which ones were not.<sup>229</sup> Hence, the government simply compensates for the land’s current fair market value, no questions asked.

Alternatively, how might an insurance-based compensation system solve this problem? If a landowner knew she would be paid the market value of her property under her takings insurance policy, why wouldn’t she similarly go ahead with the planned renovations, and then collect the increased payout from her insurance carrier if the state tore them down? The brief answer is that private insurers could prevent the excess improvement problem by requiring homeowners to pay higher premiums (or deductibles or co-payments) when they engaged in making improvements to their land where eminent domain actions appeared imminent. For a complete discussion of insurance companies’ ability to mitigate the problem, *see infra*, Part III.D.1.

## 2. Administrative Costs of Raising Taxes to Fund and Pay Out Just Compensation

Besides the excess-improvement-of-land dilemma, two categories of administrative costs are created when the state pays compensation to impacted landowners: first, the costs and distortions associated with raising the necessary revenue through our tax structure, and second, those administrative costs incurred in conjunction with the actual payout of compensation itself.<sup>230</sup>

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<sup>225</sup> See SHAVELL, *supra* note 39, § 6, at 11–12.

<sup>226</sup> See *Rainey*, 275 So. 2d at 552–53; *Saratoga Fire Prot. Dist.*, 97 Cal. App. 4th at 898; *Md.-Nat’l Capital Park*, 792 A.2d at 291–92.

<sup>227</sup> See SHAVELL, *supra* note 39, § 6, at 11–12.

<sup>228</sup> See *id.* at 12.

<sup>229</sup> See *id.*

<sup>230</sup> See SHAVELL, *supra* note 7, § 11, at 14.

The administrative costs of the tax system in the United States—most prominently, the maintenance of the Internal Revenue Service—are far from trivial.<sup>231</sup> For instance, Joel Slemrod estimates that approximately \$75 billion is spent annually on administering our revenue collection structure.<sup>232</sup> Other experts placed the figure at double that amount or greater, meaning that twenty or more cents out of every tax dollar are spent on the overarching bureaucracy of the system rather than paying for useful social programs.<sup>233</sup> Louis Kaplow notes that “although the issue of how much distortion results from various taxes is quite controversial and complex, . . . it is probably reasonable to assume that increases in taxes impose some nontrivial efficiency cost.”<sup>234</sup> Moreover, Cordes and Weisbred’s study of property seized by eminent domain found that twenty-three cents out of every “just compensation dollar” is lost in administrative costs.<sup>235</sup> That is not to say that this money is completely wasted in the pure derogatory sense of the word, for of course some administrative structure is necessary in order to direct funds to their proper uses. However, it is necessarily the case that the revenue that pays for these administrative costs is not available to the public for other productive uses. Additionally, the presence of any tax system at all inevitably distorts individuals’ behavior, including their employment and purchasing decisions.<sup>236</sup> Taxes by definition impose costs on socially valuable activities, thus decreasing marginal incentives to engage in those actions.<sup>237</sup>

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<sup>231</sup> See Daniel S. Goldberg, *Fundamental Tax Reform and the Transition to a Currency-Free Economy*, 20 VA. TAX REV. 25–29 (2000); see also Steve P. Calandrillo, *An Economic Analysis of Intellectual Property Rights: Justifications and Problems of Exclusive Rights, Incentives to Generate Information, and the Alternative of a Government-Run Reward System*, 9 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 301, 337–38 (1998) (discussing the administrative costs involved in raising revenue through taxes to fund a government-run reward system in lieu of our nation’s current intellectual property regime).

<sup>232</sup> See Joel Slemrod, *Which Is the Simplest Tax System of Them All?*, in *ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM* 355, 368 (Henry J. Aaron & William G. Gale eds., 1996).

<sup>233</sup> See ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* 7 (2d ed. 1995) (finding that the direct costs of running the federal income tax system would be \$159 billion in 1985, a significantly greater amount than Slemrod’s approximation); see also Goldberg, *supra* note 231, at 27 (noting that whether the “administrative costs [of the tax system] amount to \$75 billion, \$159 billion, or even \$275 billion, they are nevertheless very large”).

<sup>234</sup> See Kaplow, *supra* note 190, at 556 n.134.

<sup>235</sup> See Joseph J. Cordes & Burton A. Weisbred, *When Government Programs Create Inequities: A Guide to Compensation Policies*, 4 J. POL’Y ANALYSIS & MGMT. 178, 190 (1985).

<sup>236</sup> See Kaplow, *supra* note 190, at 556 (noting that the degree of economic distortion in decision-making and the incidence of tax evasion usually increases with the tax rate, suggesting that the “revenue costs” of compensation should further discourage its use).

<sup>237</sup> See *id.* Some taxes are of course designed to discourage socially harmful behavior, but all items and activities taxed by the government possess some social value. Whether or not the activity is on net socially desirable (for instance, earning wages clearly is), the presence of a tax inevitably diminishes the incentive for individuals to engage in it.

Secondly, administrative costs infect the government compensation process itself, as this is often an arduous task in the current eminent domain system. Once the state decides to take land (a decision itself that is often quite time and resource consuming), it must estimate the fair market value of the property condemned.<sup>238</sup> Disputes almost always arise in the course of this calculation,<sup>239</sup> and commentators such as Patricia Munch have argued that eminent domain is not more efficient than the free market in consolidating land and providing reimbursement.<sup>240</sup> In practice, prices paid by the state under eminent domain may differ systematically from the fair market value standard.<sup>241</sup> Evidence from urban renewal studies indicates that owners of high-value properties frequently obtain more than fair market value, while low-value properties receive less.<sup>242</sup> Hearings are often held to arbitrate the disputes, adding further administrative costs to the compensation process.<sup>243</sup> While the exact magnitude of these costs is difficult to quantify, it is clear that the current just compensation system frequently encounters opposition and obstacles, and is quite costly to administer.<sup>244</sup>

Thus, economic scholars have traditionally agreed that “just compensation leads to inefficiency if capital and insurance markets are perfect, governments do not suffer from fiscal illusion, and the takings decision is based on social welfare

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<sup>238</sup> Entire books have been dedicated to the fair market value calculation in the context of eminent domain actions, including *Current Condemnation Law: Takings, Compensation and Benefits*. See *CURRENT CONDEMNATION LAW*, *supra* note 112. The Washington Real Property Deskbook states that fair market value is defined as “the amount of money that a well-informed purchaser, willing but not obliged to buy the property would pay, and which a well-informed seller, willing but not obliged to sell it would accept, taking into consider[ation] all uses to which the property is adapted and might in reason be applied. WASHINGTON REAL PROPERTY DESKBOOK § 74.7(1) (3d ed. 1996), *citing* *Shields v. Garrison*, 957 P.2d 805, 807 (Wash. Ct. App. 1998). Moreover, owners are entitled to the value of their land in its “highest and best use.” See David M. Champagne, *Interim Highest and Best Use: Condemnation Appraising*, 69 *APPRAISAL J.* 19 (2001).

<sup>239</sup> Calculation of fair market value invariably fails to please some displaced landowners who subjectively attach higher values to their land than does the market. Moreover, the administrative costs of the process and the disputes it engenders are significant, as evidenced alone by the fact that one of the leading treatises on the subject, *Nichols on Eminent Domain*, devotes several chapters to it, including volume 6, chapter 25 (*Administrative and Legislative Techniques for Resolving Vested Rights and Condemnation Issues*), and volume 7, chapter 4 (*The Appraisal Process in Eminent Domain*). See *NICHOLS*, *supra* note 90.

<sup>240</sup> See Munch, *supra* note 77, at 473.

<sup>241</sup> See *id.* at 479–85.

<sup>242</sup> See *id.*

<sup>243</sup> See 6 *NICHOLS*, *supra* note 90, at ch. 25 (discussing administrative and legislative techniques for resolving vested rights and condemnation issues); see also H. Dixon Montague, *The Wonderful World of Eminent Domain: A Factual Analysis of a Fantasy World's Determination of Just Compensation*, *INSTITUTE ON PLANNING, ZONING, AND EMINENT DOMAIN PROCEEDINGS* 12-1 (1992).

<sup>244</sup> See Cordes & Weisbred, *supra* note 235, at 190.



maximization and not the result of rent seeking.”<sup>245</sup> That is not to imply that the alternative takings insurance system I discuss below is costless, for certainly there would be significant administrative expenses associated with the collection of insurance premiums and the settling of claims.<sup>246</sup> However, it is reasonable to surmise that these private insurance market costs would be less than the great administrative costs generated by the public tax system and the current government-based reimbursement process.<sup>247</sup>

### 3. *Administrative and Transaction Costs of Taking Land*

Finally, society’s current eminent domain regime is subject to substantial administrative and transaction costs when it comes to the initial determination of whether or not to take land in the first place. Long public debates, county meetings, and endless hearings are held about whether the proposed public project is necessary or even desirable.<sup>248</sup> Assuming that the government can achieve consensus regarding the need to engage in the taking, bitter fights ensue due to the “not in my backyard” phenomenon.<sup>249</sup> Affected landowners provide compelling reasons why the transportation project in question should run through a different neighborhood instead of their own. Sadly, it is often the wealthy and politically powerful interest groups that win this battle,<sup>250</sup> convincing the state or

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<sup>245</sup> See Shubha Ghosh, *Takings, the Exit Option, and Just Compensation*, 17 INT’L REV. L. & ECON. 157, 157 (1997) (pointing out that compensation for takings cannot be justified on efficiency grounds unless one of the above imperfections exist). Ghosh notes, however, that such imperfections do frequently occur, providing reasons to be cautious with implementing a takings insurance alternative to state-based just compensation. *Id.*

<sup>246</sup> See SHAVELL, *supra* note 7, § 11, at 14.

<sup>247</sup> See *infra* Part III.D.2 (discussing the administrative cost advantages of insurance over government-based reimbursement).

<sup>248</sup> See, e.g., Emory Bundy, *Alternatives to Light Rail in Seattle: The Campaign for Sensible Transportation*, at <http://publicpurpose.com/ut-bundy001110.htm> (last visited Apr. 7, 2003) (mounting strong resistance to the proposed light rail project in Seattle); see also Public Interest Transportation Forum, at <http://www.globaltelematics.com/pitf> (last visited Apr. 7, 2003) (offering a forum for public discussion and debate over the proposed transportation projects in the Puget Sound).

<sup>249</sup> See, e.g., Larry Lange, *Mixed Ruling for Sound Transit: Trial Set on Rainier Valley Discrimination Charge*, SEATTLE POST-INTELLIGENCER, July 17, 2001, at B1; Elaine Porterfield & George Foster, *Rainier Valley Rail Foes File Suit*, SEATTLE POST-INTELLIGENCER, Apr. 27, 2000, at B2 (claiming that the rail line would wreak havoc on the largely minority and low-income neighborhood of Rainier Valley). For a more general discussion of the “not-in-my-backyard” problem, see Denis J. Brion, *An Essay on LULU, NIMBY, and the Problem of Distributive Justice*, 15 B.C. ENVTL. AFF. L. REV. 437 (1988).

<sup>250</sup> See Aaron N. Gruen, *Takings, Just Compensation and Efficient Use of Land, Urban and Environmental Resources*, 33 URB. LAW. 517, 543 (2001) (supporting “public choice theory” findings that special interest groups may exert disproportionate political influence in eminent domain decisions, distorting the relevant cost-benefit analysis).

local municipality that the land is better taken in poor or minority neighborhoods than in their own.<sup>251</sup>

These inefficiencies and injustices associated with the initial takings determination are substantial, but would largely remain even if an insurance-based compensation structure replaced mandatory government reimbursement. In both scenarios, the state would still be subject to the numerous costs and disputes involved in determining whether or not to exercise its eminent domain power. However, I argue in Part III.D.6 that the location of the land-taking decision may actually be more just and sensible if the government knows that private insurance is the compensation mechanism (and not the state's own coffers). One might reasonably think that the state will no longer have an excess incentive to choose land in poor areas where its just compensation burden would be minimized. Rather, the state can take the property where it is most effective and desirable to locate the public transportation project, absent worries about needing to compensate for this potentially more valuable land.<sup>252</sup>

Thus, it is clear that while state provision of property is sometimes necessary to serve the greater public good, there are inevitable drawbacks that accompany mandatory government reimbursement to displaced landowners. Excess incentives to invest in improving one's land are created, and significant administrative costs to raise the necessary tax revenue and to pay out just compensation are generated. So, we owe it to ourselves to ask: is there a better method to reimburse negatively impacted property owners than that which is in place today?

### C. Abolish Just Compensation—Use Takings Insurance Instead

It would be irresponsible to complain about the problems posed by government payment of just compensation without suggesting an alternative scheme that might better serve society. Several law and economics scholars have

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<sup>251</sup> See Dan Feldstein, *United We Stand, Divided We Drive: Professor Surveys Impact of U.S. Cars*, HOUS. CHRON., Dec. 21, 1997, at 22 (reviewing TOM LEWIS, *DIVIDED HIGHWAYS: BUILDING THE INTERSTATE HIGHWAYS, TRANSFORMING AMERICAN LIFE* (1997)). Feldstein cites to Lewis's study of the "razing of inner-city minority neighborhoods by new highways" and Lewis's conclusion that such "'urban renewal' was likely racist." *Id.* However, in the minds of highway engineers, "such neighborhoods had the lowest property values and thus were the most practical buys for condemnation." *Id.* For a news account of the discriminatory impact of land takings, see David Quigg, *Chorus of Boos Against Light Rail Increases in Volume: Rainier Valley Activists Claim Racial Discrimination, Ask for U.S. Probe*, TACOMA NEWS TRIB., Aug. 5, 1999, at B1.

<sup>252</sup> However, see *infra* Part III.D.5, the disparity of political power between the wealthy and poor would continue to be a problem even if insurance replaced government compensation. Moreover, if governmental bodies began to excessively take highly valuable land once their fiscal responsibility was eliminated, the eminent domain location decision may still be suboptimal.

detailed the possibility of switching to an insurance-based reimbursement regime in lieu of today's government-based payment to affected landowners.<sup>253</sup>

As a backdrop to the debate, we should remember that current takings jurisprudence operates from the framework that state-based disbursement of just compensation is required for two primary reasons. First, state-paid just compensation serves the principle of fairness—no one should be involuntarily deprived of property without receiving its equivalent value. Second, government reimbursement protects the investment expectations of risk-averse individuals against the chance that their land will someday be taken in the name of the greater public good.<sup>254</sup> No one seriously questions these goals or lacks sympathy for displaced property owners. Quite to the contrary, it would be manifestly unjust to take private property without any due process and without any form of reimbursement whatsoever. The real question is simply whether the *government* is the best body to provide the remuneration. Neither the fairness-based desire to reimburse impacted landowners, nor the noble goal of insuring them against risk, is a sound justification for state payment of just compensation.<sup>255</sup> It is merely a justification for *some* form of compensation. No one wants to leave property owners out in the cold; rather, the issue is how to best compensate aggrieved landowners for their loss without causing any unintended side effects.

The solution: takings insurance. On balance, a compelling case can be made that state payment of just compensation is inferior to private insurance-based reimbursement. Takings insurance would be quite similar to automobile, title or homeowner's insurance, all of which cover property holders in the event of life's random unpleasanties. Most people are risk averse to some degree and guard against chance by purchasing a substantial amount of insurance in their everyday lives.<sup>256</sup> When unfortunate events arise, insurance holders are thus not left hopeless; rather, they receive compensation to help defray the costs incurred and minimize the damage done. In this manner, property owners are reimbursed for losses sustained and are effectively insured against risk. There is no principled

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<sup>253</sup> See Farber, *supra* note 137, at 285, 305 (inquiring whether insurance might work well instead of government-paid just compensation); Kaplow, *supra* note 190 (addressing both positives and negatives of insurance, and arguing that state-paid just compensation is not desirable or defensible on traditional grounds); Michelman, *supra* note 188 (asking whether government-provided just compensation is necessary). *But cf.* Blume & Rubinfeld, *supra* note 137, at 593–94 (detailing the moral hazard problem inherent in using takings insurance as a substitute for state-based compensation).

<sup>254</sup> See Fischel & Shapiro, *supra* note 126, at 269–70.

<sup>255</sup> See Kaplow, *supra* note 190, at 522–32.

<sup>256</sup> See PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 186–87 (15th ed. 1995) (detailing how insurance markets spread risk among individuals). In addition, Shavell indicates that accident and liability insurance is widely held in America. “An indication of its salience is that over 90% of all payments made to tort victims are paid by liability insurers.” SHAVELL, *supra* note 7, § 5, at 7.

reason why takings insurance could not serve the same function to landowners affected by physical or regulatory takings of their real property.<sup>257</sup>

However, a skeptic might immediately inquire why property owners should be expected to pay increased insurance premiums in order to reimburse themselves should the government take their land away. If the state procured it for some greater public good, one might reasonably argue that the state should be the party paying compensation—the burden should not fall on the landowner's shoulders. This argument seems logical in form, but it is incomplete. Today, all citizens are in effect paying public takings insurance in the form of increased taxes to our government in order to fund the state's power of eminent domain.<sup>258</sup> Since we know payment of just compensation is always required (at least for physical land takings), the state must raise the money necessary to remit to affected individuals. Such resources do not grow on trees; they come straight out of the taxpayer's pocket—just compensation is not a free lunch.

Suppose for example that each individual property owner faces a 1/10 of 1% chance that her land, valued at \$100,000, will be taken for public use. The actuarially fair insurance premium against such an occurrence would be  $(.001 \times \$100,000) = \$100$ .<sup>259</sup> Conversely, if the government is responsible for paying compensation, it must impose taxes to finance its takings—and the average increase in each individual's tax liability necessary to reimburse for the taking will be roughly the same as the insurance premium, \$100. So either way—whether the state pays just compensation derived from property owners' hard-earned tax money, or whether individuals buy private takings insurance instead, the outlay of dollars from the average individual's perspective is theoretically the same.<sup>260</sup> If we change the rules of eminent domain reimbursement so that the

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<sup>257</sup> See SHAVELL, *supra* note 7, § 11, at 13–14.

<sup>258</sup> See *id.* One should be quick to note that not all citizens bear the same tax burden, as of course, rates and amounts vary depending on wealth. Similarly, private takings insurance premiums would not be distributed equally, as owners of high-value property would be required to pay more to insure their land than owners of low-value land.

<sup>259</sup> "Fair" insurance implies that premiums exactly equal expected liability. There is no additional charge to reflect overhead, profits, or any other rents exacted by the insurance company. See SHAVELL, *supra* note 7, § 5, at 3–5.

<sup>260</sup> See *id.* § 11, at 13–14. Of course, this is a very simplified example. It is quite possible that some landowners will now be made somewhat worse off if their takings insurance premiums are greater than the portion of their income taxes that were previously allocated to just compensation payouts (and other landowners will be made slightly better off if the reverse is the case). On net though, it is reasonable to believe that taxes could be reduced by roughly the same amount as insurance premiums raised. In fact, I argue that taxes would fall by an even greater amount than insurance premiums charged because of efficiency and monitoring advantages that private insurers possess vis-à-vis the government eminent domain compensation system. See *infra* Parts III.D.1 and III.D.2. Thus, even if the switch to takings insurance is not a pareto improvement (because at least one party is made worse off), it ideally

government is absolved of its obligation to pay just compensation, the tax dollars attributable to takings reimbursement could be returned to the taxpayer's wallet. The same \$100 previously spent on eminent domain taxes would then be available for the purchase of takings insurance without a net increase in cost to the average individual.<sup>261</sup>

In reality, however, would such an insurance market actually emerge to provide the service described above? Bell and Parchomovsky cite to the current absence of takings insurance in the market as evidence that it would not likely arise,<sup>262</sup> but that may be explained by the fact that there is relatively little need for it today. It is quite plausible to believe that if government reimbursement were eliminated, the answer to the question of whether a takings insurance market would emerge is yes—just like extensive insurance markets have developed in the last century to protect against risk in a broad range of contexts.<sup>263</sup> For example, property owners currently purchase title insurance, homeowners insurance, automobile insurance, and even flood, fire and earthquake insurance.<sup>264</sup> There is no reason to think that takings insurance—especially in the

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should satisfy the Kaldor-Hicks notion of efficiency (that the winners gain more than the losers lose, and that overall social welfare is therefore increased).

Nevertheless, some observers may still find it unfair that landowners are being asked to finance compensation through private insurance, arguing that public use of one's formerly private land should be paid for with public tax dollars—not by the landowner who is the “victim” of a taking. Others might respond that paying private takings insurance premiums might be seen as more fair than accomplishing reimbursement through public taxation, since only private landowners who might someday receive the payouts will be asked to fund them (instead of taxing all citizens to accomplish this purpose, many of whom will never be landowners eligible for reimbursement).

<sup>261</sup> As stated above, this argument assumes that insurance can be purchased at actuarially fair rates and that there are no administrative costs. From an economics perspective, such fair premiums would exclude any excess rents siphoned off by the provider insurance company. In reality, no insurance is perfectly fair to consumers, but the extra rents companies make are usually only 10–12% of the total premium. See James B. Roche, *Health Care in America: Why We Need Universal Health Care and Why We Need It Now*, 13 ST. THOMAS L. REV. 1013, 1025 (2001) (noting that private health insurance firms were forced to utilize “approximately 12% of all premiums collected on administrative costs,” although this figure was worse than that for government supervised programs such as Medicare and Medicaid). Other news accounts report that the premiums insurance companies collect were actually *less than* the amount paid out to customers in recent years. See Karen Gullo, *Insurance Companies Face Second Worst Year in History*, J. REC. (Okla. City), May 25, 1994, available at 1994 WL 4775056.

<sup>262</sup> See Abraham Bell & Gideon Parchomovsky, *Takings Reassessed*, 87 VA. L. REV. 277, 308 (2001).

<sup>263</sup> See Ins. Info. Inst., *supra* note 24. The facts page of the Insurance Information Institute's website indicates that an astonishing \$735 billion was spent in year 2000 on premiums for property, casualty and life insurance.

<sup>264</sup> See *id.*

physical land takings context—would be any different.<sup>265</sup> It would provide the same benefit to the landowner that just compensation does today. Moreover, the insurance cost in terms of premiums paid would be similar to, and probably even less than, the amount of taxes that property owners currently pay to fund state-required compensation today.<sup>266</sup>

But, what about the risk that an individual might underestimate the probability of a government taking affecting her property, and therefore opt not to buy insurance even though she would have done so had she possessed perfect information about the true likelihood of a taking.<sup>267</sup> It is true that individuals—even risk averse ones who benefit from the purchase of insurance<sup>268</sup>—often systematically underestimate the occurrence of very low probability events.<sup>269</sup> For instance, if a government taking of one's land is likely to occur with a chance of 1 in 10,000, many people will choose to treat this probability as effectively equal to zero.<sup>270</sup> Hence, they may decide against purchasing insurance, not because it is contrary to their best interests, but because they misperceive or misunderstand risk. Then, the decision not to buy coverage comes back to haunt the property owner when the state chooses to take her land, leaving the uninsured landowner holding the bag.

This problem poses a legitimate concern, but fortunately, a solution is available: simply mandate the purchase of takings insurance. Such an action would not be unprecedented, as automobile liability insurance is required of all drivers on the road today.<sup>271</sup> One might reasonably ask though why should an

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<sup>265</sup> *But cf.* Blume & Rubinfeld, *supra* note 137, at 594–96 (detailing the problems of moral hazard and adverse selection with respect to providing takings insurance); *see also* Bell & Parchomovsky, *supra* note 262, at 308 (expressing skepticism that insurance markets would arise to protect against the risk of takings).

<sup>266</sup> It is reasonable to think that any excess in premiums charged by private insurers above expected liability is likely to be made up by greater efficiency in operation compared to government-based reimbursement. *See infra* Part III.D.2 (discussing the administrative and transaction cost advantage enjoyed by private insurers vis-à-vis the government).

<sup>267</sup> *See* Kaplow, *supra* note 190, at 602–03 (discussing the potential for insurance markets to fail where insureds are facing very low probability risks and where they might underestimate the probability of those risks).

<sup>268</sup> *See* SAMUELSON & NORDHAUS, *supra* note 256, at 185–87 (discussing the desirability of insurance to protect risk averse individuals).

<sup>269</sup> *See* Steve P. Calandrillo, *Responsible Regulation: A Sensible Cost-Benefit, Risk Versus Risk Approach to Federal Health and Safety Regulation*, 81 B.U. L. REV. 957, 1000 (2001) (describing the phenomenon of underestimation of very low probability events); W. KIP VISCUSI ET AL., *ECONOMICS OF REGULATION AND ANTITRUST* 661–63 (2d ed. 1995) (detailing the problem of systematic risk misperceptions in society).

<sup>270</sup> *See* W. Kip Viscusi, Lecture at Harvard Law School (Apr. 7, 1998) (unpublished lecture notes on file with author).

<sup>271</sup> *See* Ins. Info. Inst., *Can I Drive Legally Without Insurance?*, at <http://www.iii.org/individuals/auto/a/canidrive/> (last visited Apr. 7, 2003) (stating that “[a]lmost every state

individual have no choice in the matter? Perhaps it is a paternalistic desire of the government to see all of its citizens insured against risk. Or, perhaps it is a reflection of the fact that some people may have been uninformed about the relevant risks, whereas the government may possess better information—and therefore can legislate to protect its citizenry.<sup>272</sup> Either way, if takings insurance were systematically undervalued or underpurchased by property owners, the government could mandate the purchase of such coverage to alleviate concerns that some property owners would go uncompensated.

Moreover, we should keep in mind that the private financial effect of such a “mandatory” insurance scheme is in effect little different than today’s government-based just compensation structure. As pointed out above, state payment of just compensation is funded by individuals’ tax dollars. We all know that there is mandatory payment of taxes—no one person gets to choose whether or not she will contribute her tax dollars to any given cause, for obvious reasons.<sup>273</sup> Therefore, we should not be overly concerned about mandating takings insurance in a similar fashion. All property owners would be protected against risk, and all would receive the market-based form of insurance reimbursement instead of the public insurance that the government provides today.

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requires you to have auto liability insurance”). One should note however that there are still many uninsured motorists on the road, all of whom are choosing to violate the law and run the risk of legal consequences. Because insurance companies recognize that large numbers of drivers exist who choose not to purchase liability coverage, they also offer “uninsured motorist” coverage to law-abiding drivers. Such a policy protects one against the risk of being in an accident with a party who failed to buy liability coverage in accordance with the law.

<sup>272</sup> Another reason for mandating insurance coverage is the judgment-proof problem (best illustrated in the tort context). If a tortfeasor has few assets, she will have diluted incentives to take care, and her victim will go uncompensated (whereas insurance provides a safety net). See CALABRESI, *supra* note 213, at 58; William R. Keeton & Evan Kwerel, *Externalities in Automobile Insurance and the Uninsured Driver Problem*, 27 J.L. & ECON. 149 (1984); Gur Huberman, David Mayers & Clifford W. Smith, Jr., *Optimal Insurance Policy Indemnity Schedules*, 14 BELL J. ECON. 415 (1983). However, the judgment-proof problem is probably not of great concern in the takings context since landowners generally possess some wealth.

<sup>273</sup> One might imagine that if payment of taxes to certain causes were optional, our entire tax structure would crumble. Many individuals might very well say, “I don’t want my taxes going to provide military services, or healthcare services, or even education. I don’t use those products and so why should I pay for them?” If every citizen were allowed to opt out under such reasoning, the government would face an insurmountable free-rider problem in the collection of tax revenue. Each individual would choose not to pay for government services, preferring instead to free ride off of the tax dollars of her neighbors. No revenue would be raised, and no services would be provided in the end. See Calandrillo, *supra* note 269, at 972.

#### D. *The Effects of Switching to an Insurance-Based Compensation System: Advantages and Disadvantages*

While I have argued above that private takings insurance will accomplish the same compensation and risk protection purposes that government reimbursement provides, would private insurance actually prove *superior* to state-based just compensation? A consideration of the positives and negatives of switching to an insurance system to compensate for government takings is in order. On net, I believe that the benefits of takings insurance outweigh its drawbacks—because it reduces several of the serious problems created by mandatory government reimbursement for eminent domain actions.

##### 1. *Insurance Companies Can Monitor the “Excess Improvement” Problem*

One of the primary detractions of government payment of just compensation outlined above is that guaranteed state-based reimbursement for takings distorts a landowner’s decision regarding whether or not to improve her property.<sup>274</sup> Since she knows that the government must pay her for the full and fair market value of her land (and any improvements to it), she may often proceed with renovations where they would clearly be socially undesirable.<sup>275</sup> Recall the example discussed in Part III.B.1: a \$1 million renovation would yield an increase in property value of \$1.5 million, but would be demolished with probability equal to 50% if the government went forward with a potential public transportation project. If no compensation was provided—either government or insurance-based—it is easy to see that there would be no problem of excess improvement. The property owner would balance the cost of the improvement (\$1 million) against the benefit, *discounted by the probability that her property would be taken*—thus, the true social value of the improvement is only 50% of \$1.5 million = \$750,000.<sup>276</sup> Since she would bear all of the risk associated with a taking, she would take the 50% likelihood of loss into account and not overinvest: a certain \$1 million cost is greater than the *expected* return of only \$750,000.

Similarly, if takings insurance were introduced as the method by which society compensated against the risk of eminent domain, the companies providing such insurance would have incentives to control the excess improvement problem.<sup>277</sup> Insurance firms would simply increase the premium charged to those landowners who improved their property to reflect the increased payout that the

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<sup>274</sup> See *supra* Part III.B.1.

<sup>275</sup> See SHAVELL, *supra* note 7, § 11, at 15–16.

<sup>276</sup> See *id.* § 11, at 16.

<sup>277</sup> See *id.* § 11, at 15–16.



company would be required to make in the event of a taking.<sup>278</sup> In the scenario above, if the individual chose to go ahead with the renovation, her premium would jump by 50% x \$1.5 million, or \$750,000.<sup>279</sup> Thus, any time an individual improved her property in the face of a potential eminent domain action, insurance rates would be adjusted to reflect the new expected liability. In this manner, society's problem of encouraging investment only when socially appropriate becomes the landowner's private problem: she will proceed with improvements only if the overall gain outweighs the total costs—which will incorporate not only the cost of the improvement, but also the increased takings insurance premium to reflect the greater liability faced.<sup>280</sup>

The overarching message with respect to the insurance-based alternative to government payment of just compensation is that private takings insurance presents the ability to greatly mitigate the excess improvement problem.<sup>281</sup> By increasing premiums to reflect improvements in land value and corresponding expected liability, individuals will engage in improving land only where socially appropriate.<sup>282</sup> This is a substantial advantage provided by the insurance-based alternative to just compensation, and a far cry from the behavior witnessed in America's current mandatory compensation regime. Numerous cases have come before our courts where improvements were made to land immediately prior to its condemnation, including *Division of Bond Finance v. Rainey*,<sup>283</sup> *Saratoga Fire Protection District v. W.C. Hackett*,<sup>284</sup> and *J.L. Mathews, Inc. v. Maryland-*

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<sup>278</sup> See *id.*

<sup>279</sup> One should note that this premium is incredibly high because it has been assumed that the land in question is subject to a very high likelihood of being taken at the time that insurance coverage is being purchased. Normally, premiums would be far lower at the outset and presumably for the duration of the policy, but be adjusted upwards as improvements to land were made. Moreover, once a landowner purchased takings insurance, her rate would not skyrocket decades down the road when it suddenly appeared that the state might take her land—after all, if one owns health insurance for thirty years and then contracts leukemia, insurers are legally prevented from drastically increasing premiums to eliminate such a newly high-risk customer. Similarly, while insurers could alter premiums to reflect changes in property values due to improvements, they would be prohibited from raising premiums precipitously on previously existing coverage once a taking appears imminent—otherwise the entire takings insurance market would unravel and landowners would be unable to maintain coverage when they finally needed it.

<sup>280</sup> See SHAVELL, *supra* note 7, § 11, at 16.

<sup>281</sup> See Farber, *supra* note 137, at 285; SHAVELL, *supra* note 7, § 11, at 15–16.

<sup>282</sup> See SHAVELL, *supra* note 7, § 11, at 16.

<sup>283</sup> 275 So. 2d 551 (Fla. Dist. Ct. App. 1973) (allowing compensation for investments made by appellees immediately prior to the institution of their lawsuit).

<sup>284</sup> 118 Cal. Rptr. 2d 696 (Cal. App. 4th 2002) (owner allowed to establish that there was a substantial increase in the value of his building in the year between filing of complaint and the actual taking of his property).

*National Capital Park and Planning Commission*.<sup>285</sup> These examples of eminent domain resulted in the demolition of millions of dollars worth of buildings and improvements that might never have been constructed at the outset if the landowners involved were properly incentivized to account for the risk that their property could be taken. Instead, the owners were justly compensated, the taxpayers footed the bill, and society was certainly not better off for doing so.

## 2. *Reduced Administrative and Transaction Costs of Private Insurance*

It is also reasonable to believe that private takings insurance will more efficiently serve the public's desire to see displaced landowners compensated than does the current system requiring bureaucratic involvement.<sup>286</sup> Part III.B detailed the various administrative costs associated with state compensation for takings: namely, the costs and distortions associated with raising revenue through taxes, and the administrative costs incurred in the compensation process itself.<sup>287</sup> Neither of these costs is trivial. Twenty-three cents out of each just compensation dollar is lost to society,<sup>288</sup> and numerous conflicts ensue in the calculation of the proper fair market value to be paid out today.<sup>289</sup>

There are a variety of reasons to believe that private insurance firms are more likely to minimize the administrative and transaction costs of reimbursement compared to the state, not the least of which are the overt motives of profit-maximization and the pressures of market competition. Profit maximizing companies have a direct financial incentive to operate efficiently in order to stay in business in a competitive marketplace, whereas the government is significantly insulated from such worries about the bottom line.<sup>290</sup> True, private insurers will

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<sup>285</sup> 792 A.2d 288 (Md. 2002) (owner entitled to value of improvements to condemned property).

<sup>286</sup> For a fuller discussion of the issue of economic efficiency and compensation for takings, see Berger, *supra* note 139, at 169–70, and John Quinn & Michael J. Trebilcock, *Compensation, Transition Costs and Regulatory Change*, 32 U. TORONTO L.J. 117, 132–39 (1982).

<sup>287</sup> See *supra* Part III.B.2.

<sup>288</sup> See Cordes & Weisbred, *supra* note 235, at 190 (detailing a 1985 study of eminent domain seizures for road construction projects).

<sup>289</sup> For example, since the beginning of 2000, 229 cases have been assigned key numbers in the Westlaw topic Eminent Domain, heading II (Compensation), subheading (C) (Measure and Amount). Westlaw search conducted in ALLCASES database on April 16, 2003: da(>1999) & 148ii(c). This number generally reflects only appellate cases; many more would have been settled or resolved at a lower level.

<sup>290</sup> For proof of this assertion one need simply watch any given installment of *Nightly News* on NBC—it seems there is an endless list of government programs chronicled under the “Fleecing of America,” an overt reference to the frequent wasting of resources by the government. See *Nightly News Archive Front Page*, at <http://msnbc.com/news/>

incur significant administrative costs to cover overhead expenses, collect insurance premiums, and settle claims by the insured landowners affected by eminent domain actions.<sup>291</sup> However, common experience suggests that private insurance-related administrative costs will be small compared to those witnessed in today's regime of government compensation.<sup>292</sup> The process of hearings and appeals by which the state determines the proper fair market value of land is far more cumbersome than procedures utilized by private insurers.<sup>293</sup> Furthermore, insurance companies have an interest in streamlining the process to keep their customers satisfied, whereas the government has no such direct financial motive.

On net then, it is reasonable to believe that the administrative and transaction costs of takings insurance would be less than those incurred under today's government reimbursement structure. Studies conducted by Munch have found that the state compensation process is not only less efficient, but that the fair market value determinations are also systematically inaccurate.<sup>294</sup> Private insurers would be better able to minimize inevitable administrative and transaction costs because of market competition and the desire to maximize profits, raising another efficiency advantage of takings insurance over government-provided compensation.<sup>295</sup>

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nightlyarchive\_Front.asp (last viewed Apr. 7, 2003); *see also* Juliet Eilperin & Dan Morgan, *Capitol Hill Spending is Flush with Pork Barrel*, WASH. POST, Oct. 25, 1999, at A1.

<sup>291</sup> *See* SHAVELL, *supra* note 7, § 11, at 14.

<sup>292</sup> *See id.* For example, the cost of administering the federal Old Age and Survivors Insurance Program is about 1% of total expenditures and that of the Disability Insurance Program is about 3.5%. The cost of administering workers' compensation, however, was estimated by Munch at roughly 38%, while others estimate the cost of administering the United Kingdom's analogous "industrial injuries" system at approximately 12%. *See id.*, § 6, at n.4 (citations omitted).

<sup>293</sup> That the system is cumbersome is illustrated by the fact that the leading treatise, Nichols on Eminent Domain, currently comprises 18 hefty volumes. One entire volume (volume 4) is devoted to Valuation; other volumes and chapters address various topics, including procedural topics such as Appeals and Dispute Resolution. *See* NICHOLS, *supra* note 90. Conversely, insurance companies and real estate appraisers have devised relatively quick and easy methods to accurately measure property values. In fact, one can receive a fair market value estimate of their home over the internet in a matter of minutes today. *See, e.g.*, US Home Value: Nationwide Appraisal Data, at <http://www.ushomevalue.com> (last visited Apr. 7, 2003).

<sup>294</sup> *See* Munch, *supra* note 77, at 473, 488; *see also* Knetsch & Borcherding, *supra* note 73, at 241-42, 246-48 (contending that government-based fair market value determinations are too low to adequately compensate displaced landowners).

<sup>295</sup> However, if empirical data later indicates that the overhead and profits of private insurance companies outstrip the saving in administrative expenditures, then insurance would obviously not be preferable to state-based compensation on this ground alone.

### 3. Government's "Excess Incentive" to Take Land

Despite the behavior-monitoring and administrative cost advantages of private insurance compared to state-based compensation for takings, scholars such as Deprez, Kaplow, Fischel and Shapiro charge that absolving the government of its obligation to reimburse affected landowners would lead to perverse incentives for the state to take land in the first place.<sup>296</sup>

Up to this point, it has been implicit in my argument that the state will exercise its power of eminent domain only where it is in the public's best interest to do so. However, there is no guarantee that that will necessarily be the case.<sup>297</sup> For instance, public choice theorists cogently argue that the power of eminent domain could be abused so that those in control might benefit a small constituent group at the expense of the majority.<sup>298</sup> In addition, those in government might wield their power to punish political adversaries.<sup>299</sup> State employees might also benefit from increasing the number of takings because their salary or status may rise as the scope of their activity expands.<sup>300</sup> Further, government decision-makers might simply enjoy the sheer exercise of power even if for illegitimate ends.<sup>301</sup> Finally, accompanying the positive power of eminent domain is the risk that the government could become subject to industry capture or outright bribery by firms seeking to profit from contracts to carry out public projects, such as

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<sup>296</sup> See Johan Deprez, *Risk, Uncertainty, and Nonergodicity in the Determination of Investment-Backed Expectations: A Post Keynesian Alternative to Posnerian Doctrine in the Analysis of Regulatory Takings*, 34 *LOU. L.A. L. REV.* 1221, 1231 (2001); Kaplow, *supra* note 190, at 605 (noting that arguments concerning potential abuse of power seem to emerge as the strongest reasons in favor of keeping government compensation); Fischel & Shapiro, *supra* note 126, at 269–70; EPSTEIN, *supra* note 137, at 331–34; RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 61–68 (5th ed. 1998).

<sup>297</sup> See Fischel & Shapiro, *supra* note 126, at 269–70 (arguing that the state would over-expand by taking too many private resources if it did not have to compensate for them); Deprez, *supra* note 296, at 1231 (noting the prevailing law and economics view that the Takings Clause acts as a check on the government's potentially wasteful use of its taking power).

<sup>298</sup> See generally MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1965) (arguing that the demand for legislation is determined by the incidence and activity of special interest groups, and that small, elite groups might more easily organize in order to serve their own desires). Founding father James Madison argued similarly in Federalist No. 10 that the smaller the governing group, the more vulnerable it would be to small but powerful factions within it. *THE FEDERALIST* NO. 10, at 63–64 (James Madison) (Jacob E. Cooke ed., 1961). Moreover, government decision-makers have long been known to use their positions to support projects that benefit their local constituencies at the expense of the public good. See, e.g., Eilperin & Morgan, *supra* note 290.

<sup>299</sup> See SHAVELL, *supra* note 7, § 11, at 15.

<sup>300</sup> See *id.*

<sup>301</sup> See *id.*

highway construction.<sup>302</sup> For any or all of these reasons, the state might be tempted to abuse its power of eminent domain.

However, if the government is forced to make payment for the land it takes (or regulates), any potential tendency to abuse the takings power is reduced.<sup>303</sup> After all, why would the state take land where little public value would be served, knowing it would have to pay the fair market value of the land to the displaced property owners? Abuses would quickly come to light in the media, the responsible government officials would be disciplined, and takings would occur only where publicly justified. Conversely, if government reimbursement were not required—or if private insurance were to absolve the state of this responsibility—excess takings might very well occur.<sup>304</sup> This fear of government overzealousness and abuse does not seem to be merely an academic concern—the average property owner might reasonably worry that if the state could take her land without paying for it, then it would take far too much land.

There are counterarguments, however, to the risk of eminent domain abuse if private insurance were substituted in lieu of state-provided reimbursement. First is the simplistic notion that the government is charged with acting in society's best interests, regardless of the financial incentives of individual decision-makers. Even if the just compensation requirement were omitted from the Fifth Amendment protections accorded private property owners, there would be no deletion of the "public use" obligation and its accompanying interpretation in the caselaw. Simply because state-based compensation would be eliminated does not mean that our politicians would be given carte blanche to engage in takings at their free and unfettered will. By law, all takings must serve a public purpose, even if the stringency of that requirement has been mitigated in recent decades.<sup>305</sup> Moreover, we see no general call for the government to pay for the negative consequences of its actions outside of the eminent domain environment, even though virtually all state actions disadvantage some people.<sup>306</sup> The obvious reason society does not routinely require payment is that we assume that government motives are primarily to advance overall social welfare, and that it

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<sup>302</sup> See *id.*

<sup>303</sup> See Fischel & Shapiro, *supra* note 126, at 269–70.

<sup>304</sup> See *id.*

<sup>305</sup> See Merrill, *supra* note 94, at 61–65 (detailing the decline of the stringency of the public purpose requirement in the cases of *Poletown Neighborhood Council v. City of Detroit*, *City of Oakland v. Oakland Raiders*, and *Hawaii Housing Authority v. Midkiff*); see also Robyn Blumner, *Developers Making Profitable Use of Eminent Domain*, S.F. CHRON., July 3, 2002, at A23 (detailing the demise of the strict "public use" requirement, and noting that in parts of Illinois, "condemnation was literally for sale" to the highest corporate bidder). In fact, the Southwestern Illinois Development Authority advertised that it would take land for private use for a set fee: its "Quick-Take Application Packet" cost private developers \$2,500, plus a commission of 6% to 10% of the acquisition price. *Id.*

<sup>306</sup> See SHAVELL, *supra* note 7, § 11, at 15.

does not need to be forced to pay compensation in order to be incentivized to serve this goal.<sup>307</sup>

Secondly, and far less idealistic than the defense offered above, is the reality that government actors are often overly cautious to begin with. Rather than spurring excess takings, removing the requirement of state reimbursement might embolden public bureaucrats from their current position of excessive inertia. Political reality indicates that the status quo is almost always easier to live with, enforce and hide behind than engaging in large scale public projects—even where they would substantially increase overall social welfare. Seattle's experience with constructing a public transportation system is an excellent example.<sup>308</sup> For several decades, the Puget Sound region has been plagued by increasing congestion on its roadways, so much so that it is now ranked as the fifth worst city in the country in which to drive.<sup>309</sup> (This is despite the fact that its population is only 22nd largest nationally.<sup>310</sup>) While politicians have known of the impending transportation problem for decades, nothing of consequence has been done to solve it. This is because inertia is less risky than action. If there is too little incentive in the first place for state bureaucrats to exercise the power of eminent domain because of the political risks involved, the requirement of government-paid just compensation only exacerbates the inaction problem.<sup>311</sup> Useful public projects fall by the wayside, the problem grows exponentially worse, and sometimes reaches crisis proportions before any action is taken.<sup>312</sup> Contrary to popular wisdom, abolishing the requirement of government reimbursement might actually help alleviate the tendency for *too-few* takings currently.<sup>313</sup>

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<sup>307</sup> See *id.*

<sup>308</sup> See Eric Pryne, *Traffic Woes Bring County's Together, but Solution Might Divide Them*, SEATTLE TIMES, June 17, 2002, at B1 (detailing the terrible congestion in Puget Sound and the area's utter inability to find a solution).

<sup>309</sup> See Mike Roarke, *Traffic: We're Now 5th, but No Better off: Congestion Worse All over, Survey Finds, So Area's Fall from 2nd Is No Gain*, SEATTLE POST-INTELLIGENCER, June 21, 2002, at B1; Aaron Corvin, *Seattle-Everett Traffic Bad, Bad You Knew It, but . . . How Bad? 2nd-Worst Gridlock in Nation; Tacoma 37th*, TACOMA NEWS TRIB., May 8, 2001, at A1.

<sup>310</sup> See THE WORLD ALMANAC AND BOOK OF FACTS 390 (2000).

<sup>311</sup> See SHAVELL, *supra* note 7, § 11, at 15.

<sup>312</sup> See Drew DeSilver, *Boeing Cuts Could Trigger 'Short, Sharp' Recession*, SEATTLE TIMES, Sept. 20, 2001, at A1; Kyung M. Song, *Traffic Steams Boeing Executive: Mulally Warns That Gridlock Could Imperil More Jobs*, SEATTLE TIMES, Jan. 17, 2002, at C1 (Boeing has long argued that transportation problems are one of the main reasons that it is leaving Seattle.); Chris Isidore, *Boeing to Fly From Seattle*, CNNFN, Mar. 21, 2001, at <http://www.cnnfn.com/2001/03/21/companies/boeing>. Boeing's departure and Seattle's congestion woes have been substantial contributing factors to the severe economic downturn in the Puget Sound region.

<sup>313</sup> I do not opine that this is necessarily the case in fact, but raise the argument to illustrate the possibility that increasing the number of government eminent domain actions might actually improve overall social welfare.

In addition, there are checks on abuse of the eminent domain power, even in the absence of state payment of compensation. If government officials attempt to overuse their ability to take land regardless of the public purpose at stake (or lack thereof), their political opponents will be happy to point out their indiscretions. In our media-saturated culture, it is unlikely that any substantial government taking will go unnoticed by the watchful eyes of news reporters.<sup>314</sup> State actions are constantly held up to public scrutiny, and political figures seem quite willing to openly criticize fellow decision-makers.<sup>315</sup> In this environment, the potential for abuse of the eminent domain power is mitigated, because adverse political and media consequences will be soon to follow.

Finally, to the extent that we remain concerned that eliminating government reimbursement for land takings would produce excessive incentives for the state to take private property, we must question the degree to which mandatory payment actually solves the problem today.<sup>316</sup> The government is quite able to procure tax revenue to finance takings, and the officials making the determination regarding whether or not to procure land are not significantly impacted by the state's compensatory disbursements.<sup>317</sup> Moreover, when landowners know that state-based reimbursement will be paid, their motivation to oppose takings that are not in the public interest is reduced, again raising the prospect of excess takings even without switching to the insurance-based alternative proposed herein.

On balance, it is not clear that the problem of excessive takings by the government—assuming it were to be relieved of its requirement to pay just compensation—is insurmountable. There are checks on political abuses, and in reality public bureaucrats may be overly cautious and inactive to begin with. However, even the most ardent supporter of a private takings insurance system must admit that the constitutional requirement of just compensation provides a valuable constraint on inappropriate government decision-making, and that we must carefully monitor potential abuses presented by the elimination of mandatory government reimbursement.

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<sup>314</sup> For example, news magazine shows like Dateline NBC are seemingly on a constant quest to expose government waste, regularly running “Fleecing of America” special reports. See Nightly News Archive Front Page, *supra* note 290; see also Dick Pettys, *Pork Projects Not as Easy to Conceal for State Lawmakers*, ATHENS BANNER-HERALD, Feb. 18, 1999, at [http://www.onlineathens.com/stories/021899/new\\_0218990015.shtml](http://www.onlineathens.com/stories/021899/new_0218990015.shtml).

<sup>315</sup> See, e.g., Hal Marcovitz, *Miller Criticizes Colleagues' Pick for Purchasing: She Calls the Selection Process of 'Republican Politician' a 'Mockery'*, ALLENTOWN MORNING CALL, Oct. 5, 2000, at B3; John Sanko, *Lawmaker Vents Ire at Parade Critics: Attacks on Columbus Irk Italian-American Senator*, ROCKY MOUNTAIN NEWS, Sept. 7, 2001, at 4A.

<sup>316</sup> See SHAVELL, *supra* note 7, § 11, at 15.

<sup>317</sup> See *id.*

#### 4. Moral Hazard of Insured Landowners

Blume and Rubinfeld voice yet another criticism of the insurance-based alternative to government compensation: namely, that insured property owners would lose their motivation to fight inappropriate takings, leading to a breakdown in the takings insurance market.<sup>318</sup> This argument is based on the principle of “moral hazard,” a reference to the tendency of people to overuse products of which they do not bear the full cost.<sup>319</sup> For example, once a person owns health insurance that provides full coverage, she is more likely to see a physician for minor illnesses than if she were paying out of pocket. This is so because each additional doctor’s visit is free from her perspective—she paid her insurance premium up front, and instead of paying a fee for service to the physician each time she visits, she is fully covered for the entire year.

Similarly, once a landowner knows that her private takings insurance will reimburse her for the loss of her property, she no longer possesses the same determination to fight potential eminent domain actions—she will just rely on her insurance coverage.<sup>320</sup> One might reasonably posit that the availability of insurance would therefore reduce opposition to socially inappropriate takings, in contrast to the bitter fights witnessed today any time the government attempts to take private land.<sup>321</sup> Blume and Rubinfeld make this very argument, stating that the problems associated with insurance markets might warrant payment of government compensation as implicit insurance instead.<sup>322</sup>

Two comments should be made in response. The first is simply: yes, the presence of insurance necessarily induces a kind of moral hazard in the takings context, or in any context for that matter. There is no question that insured landowners will be far less likely to oppose a potential taking than if they were to receive no compensation at all. However, the moral hazard argument ignores the fact that state-payment of just compensation induces precisely the same dilemma that private insurance does.<sup>323</sup> If the homeowner knows that the government must

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<sup>318</sup> See Blume & Rubinfeld, *supra* note 137, at 593–97 (arguing that insurance markets might fail to provide coverage against uncompensated takings because of the moral hazard problem).

<sup>319</sup> Moral hazard is defined as the tendency of insurance to lead those covered by it to diminish precautions taken against loss. See RUFFIN & GREGORY, *supra* note 35, at 284 (discussing the effect that insurance has upon the behavior of the individual covered).

<sup>320</sup> See Blume & Rubinfeld, *supra* note 137, at 593–96.

<sup>321</sup> See, e.g., Mike Lindblom, *Foes of Monorail Getting Organized: High Taxes, Little Relief Seen*, SEATTLE TIMES, July 19, 2002, at B1 (discussing the campaign that critics of a proposed Seattle monorail are mounting against the \$1.7 billion line). One skeptic proposed that a mockup of the elevated track be built outside of the Seattle Art Museum to dramatize the loss of views currently enjoyed by landowners. *Id.*

<sup>322</sup> See Blume & Rubinfeld, *supra* note 137, at 593–99.

<sup>323</sup> See SHAVELL, *supra* note 39, § 6, at 7–8.



reimburse her for land value deprived, she would be equally lax in failing to resist proposed takings.<sup>324</sup> Thus, whether the state pays or whether an insurance company pays, homeowners' moral hazard provides a reduced incentive to fight the exercise of eminent domain compared to a world in which no compensation at all is provided.<sup>325</sup>

Why then do we witness such hostile disputes today when the government proposes to take private land? There are several reasons, not the least of which is the inconvenience and unpleasantness associated with being forced to move. It is a difficult experience to be displaced even if one knows that she will receive fair market value in return. Secondly, as Knetsch and Munch separately observe, the government's estimate of fair market value may be systematically lower than a private owner's subjective valuation of her land.<sup>326</sup> This may be due to sentimental values that homeowners attach but which the government cannot measure nor reimburse.<sup>327</sup> It may also be related to the psychological endowment effect described in Part II.B: once a property owner possesses the legal right to a particular piece of land, the amount she is willing to accept in order to sell that property is often far in excess of that which she would be willing to pay to buy it had she not been in possession.<sup>328</sup> Thus, government estimates of just compensation may frequently leave displaced landowners dissatisfied, giving them a compelling reason to oppose potential exercises of eminent domain.

This reality would likely not be altered by a switch to insurance-based compensation. Landowners who valued their property at subjectively greater valuations than that of the fair market would dispute the compensatory amounts offered and thus be similarly motivated to resist takings.<sup>329</sup> More importantly, large insurance firms that represented numerous affected property holders would have a tremendous motivation to oppose government takings because their

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<sup>324</sup> See *id.*

<sup>325</sup> One corner solution to the just compensation debate is simply to provide none at all. This would cure the dilemma of landowners failing to resist takings, but would obviously expose them to an incredibly high degree of risk. See Cooter, *supra* note 199, at 21.

<sup>326</sup> See Knetsch & Borchering, *supra* note 73, at 240–42; Munch, *supra* note 77, at 488 (finding that low-value parcels of land systematically receive less than their fair market value in terms of just compensation).

<sup>327</sup> See Knetsch & Borchering, *supra* note 73, at 240–41.

<sup>328</sup> See *id.* (indicating that subjective valuations greater than fair market value could be construed to mean that a person would often not accept government estimates of market price in order to sell their land). *But cf.* Fischel, *supra* note 73, at 196–99 (criticizing the argument that the endowment effect justifies greater than fair market valuation of taken property).

<sup>329</sup> Alternatively, to combat the problem of inadequate just compensation payouts today, a property owner could voluntarily insure her property up to her greater subjective valuation amount if she so desired. Such an action would necessarily improve landowner welfare vis-à-vis today's reimbursement system, for why else would a property owner voluntarily insure against an amount greater than fair market value (and therefore pay more in insurance premiums) unless doing so made her better off.

pockets would be on the line.<sup>330</sup> Hence, one might expect significant lobbying efforts on the part of large insurers to combat any potential exercise of eminent domain where the public good was not well served.<sup>331</sup>

Furthermore, the moral hazard problem in the context of takings insurance would not seem to be much more serious than it is with respect to all kinds of insurance that is currently sold on the market (like medical, homeowner's or fire insurance).<sup>332</sup> While moral hazard exists, raising insurance premiums is the most obvious and direct way to combat the problem. Property owners would still possess an incentive to resist inappropriate takings because failing to do so would increase their cost in the long run—to reflect the greater chances of proposed takings going forward.

Finally, insurance providers have dealt with the moral hazard problem in other contexts by introducing deductibles and co-payments.<sup>333</sup> A deductible is an amount that must be met before the insurance company will begin reimbursement.<sup>334</sup> In the healthcare arena, even where the patient owns insurance, it is often the case that each doctor's visit is no longer free.<sup>335</sup> Often, the first \$200 or more worth of annual care must be paid by the patient as a deductible; it is only for amounts above this threshold where insurance will kick in. Similarly, co-payments require that the insured customer bear a portion of the costs each time she uses the product covered.<sup>336</sup> Individuals must therefore pay \$10 to \$20 per visit to their doctor. The insurance companies' goal is to reflect at least some of the additional costs associated with additional use.<sup>337</sup> This shifts some of the burden and risk back onto the insured individual, making her less

<sup>330</sup> See SHAVELL, *supra* note 39, § 6, at 8.

<sup>331</sup> A more cynical observer might suggest that the insurance industry would attempt to use its clout to "capture" government actors involved in making eminent domain decisions. This could possibly lead to an even lower incidence of takings than that witnessed today, despite the fact that the state would not bear any compensation burden.

<sup>332</sup> See Kaplow, *supra* note 190, at 540 n.86. Farber notes, however, that Kaplow may overstate this point, as it seems easier to monitor the precautions that insureds take to prevent fires than it does to monitor the actions that insured landowners take in the takings insurance context. Farber, *supra* note 137, at 284 n.15.

<sup>333</sup> See Karen Eggleston, *Risk Selection and Optimal Health Insurance-Provider Payment Systems*, 67 J. RISK & INS. 173, 173 (2000) (noting that consumers may also prefer to pay deductibles and co-payments).

<sup>334</sup> See MARGARET R. O'LEARY, *LEXIKON: DICTIONARY OF HEALTH CARE TERMS, ORGANIZATIONS, AND ACRONYMS FOR THE ERA OF REFORM* 240 (1994).

<sup>335</sup> See BARRY R. FURROW ET AL., *1 HEALTH LAW: PRACTITIONER TREATISE SERIES* 469 (2d ed. 2000) (discussing common methods by which insurers share costs with the individuals they cover).

<sup>336</sup> See O'LEARY, *supra* note 334, at 217.

<sup>337</sup> See FURROW ET AL., *supra* note 335, at 469–70 (stating that in recent years, employee cost-sharing has tended to increase).

likely to abuse her coverage.<sup>338</sup> Similarly, in the takings insurance context, companies could impose relatively high deductibles on insureds who make claims for land takings. By forcing individuals to bear some of the bite of eminent domain, the insurance provider will help incentivize landowners to resist takings where it is appropriate to do so.<sup>339</sup>

In sum, it seems unlikely that the moral hazard of insured property owners facing the risk of eminent domain actions will be any worse than the moral hazard of government-compensated landowners. The argument is thus not a compelling basis on which to oppose switching to takings insurance in lieu of mandatory state compensation.

### 5. *Distributive Impact of Takings Insurance Versus Government Compensation*

Next, critics contend that moving to an insurance system in lieu of state payment for takings might disproportionately hurt the poor—who would have a more difficult time than their affluent neighbors in purchasing takings insurance.<sup>340</sup> This is a valid concern, for today's state-based compensation at least guarantees lower income property owners reimbursement, whereas takings insurance might be more difficult for them to afford. Further, mandatory government reimbursement might also protect the indigent and minorities from inappropriate and discriminatory eminent domain actions.

While this distributive justice argument has intellectual appeal, its application in practice is limited. First, very low income individuals are unlikely to own large parcels of property subject to the potential exercise of eminent domain. To the extent that such individuals disproportionately *rent* land or apartments that are eventually taken, the just compensation paid is not directed towards them. Rather, it flows to landlord-owners, who tend to be better off financially than their lessee-

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<sup>338</sup> *See id.*

<sup>339</sup> Note however that anything less than full coverage will expose landowners to some risk, which is not ideal if they are risk averse. However, if the small risk imposed on insureds prevents moral hazard from occurring, the overall social welfare may be greater than if companies provided full insurance coverage.

<sup>340</sup> For a general discussion of the distributional effects of compensation, see Blume & Rubinfeld, *supra* note 137, at 580–82. For a provocative assessment of whether the law should account for distributive considerations at all, see Steven Shavell, *A Note on Efficiency vs. Distributional Equity in Legal Rulemaking: Should Distributional Equity Matter Given Optimal Income Taxation?*, 71 AM. ECON. REV. PAPERS & PROC. 414 (1981); and Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient Than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 681 (1994) (arguing that the law ought not to be used to redistribute wealth because the income tax system is available and superior in achieving that purpose).

renter counterparts. So, even today, not much government-based compensation is actually provided to very low income individuals.<sup>341</sup>

Moreover, a portion of the tax dollars that the poor are currently paying today goes to support the funding of just compensation—even if they are less likely to receive it because they own considerably less property than their wealthy counterparts. True, taxes are progressive in America, so the poor's share of the reimbursement burden is less than the rich.<sup>342</sup> However, as mentioned above, landowners subject to the risk of eminent domain are not likely to be very poor, and hence do pay a fair amount of taxes. Just because they later receive compensation does not mean it was a net distributive gain—because they have presumably been paying taxes into the system for many years prior to the taking. Further, numerous landowners pay such taxes without ever receiving government compensation because most property is never commandeered.

Finally, if there remained concern that the poor would disproportionately decide against purchasing takings insurance because of information problems or financial burdens, society could mandate its purchase, just as it does today with automobile liability coverage.<sup>343</sup> In this manner, no one would be left exposed to risk, not even the poor. Moreover, the argument that the poor would be worse off if they were forced to buy coverage loses force when one realizes that that is in effect the system we have in place today. All drivers must purchase liability coverage regardless of their income level. All citizens must pay taxes—no portion is optional—and a portion of the poor's tax dollars goes to fund just compensation, whether or not they benefit from it.<sup>344</sup> If the poor were required to pay insurance premiums instead, those premiums would be offset by correspondingly decreased taxes.<sup>345</sup> Thus, it is difficult to argue that the poor

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<sup>341</sup> However, where the poor do own property subject to eminent domain, they are indeed reimbursed under our current system, just as they would be under a takings insurance regime. It is not obvious that asking the poor to pay insurance premiums to cover their land would be categorically worse than the taxes we require them to pay today to help fund eminent domain compensation.

<sup>342</sup> However, the U.S. has one of the least progressive tax structures of any developed country, meaning that the poor bear a larger proportion of the burden in America than in most other comparable nations. For a comparison of tax rates in the European economic community, see ISABELLE JOUMARD, *TAX SYSTEMS IN EUROPEAN UNION COUNTRIES* (Organisation for Econ. Co-operation & Dev., Econ. Dep't Working Paper No. 301, June 29, 2001), available at <http://www.oecd.org/pdf/M00003000/M00003511.pdf> (last visited Apr. 7, 2003).

<sup>343</sup> See *Ins. Info. Inst.*, *supra* note 263 (noting that automobile liability coverage is mandatory in nearly every state, although that fails to prevent many motorists from driving while uninsured).

<sup>344</sup> See *supra* Part III.C.

<sup>345</sup> Although, if one is poor enough so as not to be required to pay any taxes today, but she still owns property, the switch to mandatory takings insurance would involve a net additional cost to that individual. However, as discussed above, there are relatively few individuals whose

would be categorically worse off if takings insurance replaced mandatory government reimbursement.<sup>346</sup>

### 6. *Where Would Land be Taken if Just Compensation were Abolished?*

Related to the distributional justice argument offered above is the concern that the state might disproportionately take land in poor and minority areas when it chooses to exercise its power of eminent domain.<sup>347</sup> Would this problem be worse if just compensation by the government were replaced by private takings insurance?

Today, there are several reasons why the state might indeed be tempted to take land in poorer areas as opposed to more wealthy neighborhoods. First, the poor often have less of a political voice and do not vote in the same percentages as their wealthy counterparts.<sup>348</sup> This relative disenfranchisement has negative consequences for the placement of public projects. If the wealthy are the ones screaming loudest, “Not in my backyard,” it is little wonder why these projects often wind up being placed in poorer communities.<sup>349</sup> Moreover, since the government knows it must reimburse landowners for the fair market value of property taken, its direct financial incentives are to procure the lowest value property possible—again, which is more likely to be located in poor and perhaps minority communities.<sup>350</sup> Quite simply, the incentives under today’s structure of

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income is below the threshold required to pay taxes, but who also own property that could be subject to eminent domain actions.

<sup>346</sup> However, an argument could be made that the poor would be worse off if the reduction in taxes once mandatory government compensation is abolished is less than the amount of insurance premiums charged. In theory, this should not be the case, especially if private insurers can operate more efficiently than state-based reimbursement can. *See supra* Part III.D.2 (discussing the administrative cost advantages of insurance over state-provided compensation).

<sup>347</sup> *See, e.g.,* Sean Selman, *Pathways to Displacement: Researcher Examines How Route of U.S. Interstates Reshaped Racial Landscapes*, BLACK ISSUES IN HIGHER EDUC., Aug. 31, 2000, at 15 (noting that U.S. interstates have had a dramatic impact on reshaping racial landscapes).

<sup>348</sup> *See* Federal Election Comm’n, *Voter Registration and Turnout by Age, Gender & Race*, at <http://www.fec.gov/pages/98demog/98demog.htm> (last visited Apr. 7, 2003); Federal Election Comm’n, *Voter Registration and Turnout in Federal Elections by Race/Ethnicity 1972–1996*, at <http://www.fec.gov/pages/Raceto.htm> (last visited Apr. 7, 2003).

<sup>349</sup> *See generally* Gruen, *supra* note 250, at 522 (noting that public choice theory suggests that special interest groups exercise disproportionate influence in eminent domain decisions, distorting society’s cost-benefit analysis); *see also* Selman, *supra* note 347, at 15. Dr. Ray Mohl, chair of the history department at the University of Alabama, argues that postwar policymakers “used interstate construction to destroy minority neighborhoods, part of a concerted effort to reshape the racial landscapes of American cities.” *Id.*

<sup>350</sup> *See* Feldstein, *supra* note 251, at 22 (discussing Tom Lewis’ study of the U.S. interstate transportation system). Feldstein laments the razing of inner-city minority

eminent domain compensation are perverse from the poor's perspective. As Tom Lewis' study concluded, their land is more likely to be taken because their voice is squashed and their property values are lower, thus reducing the government's reimbursement burden.<sup>351</sup>

Conversely, if takings insurance were substituted for state payment of compensation, the government would worry less about the financial impact of eminent domain actions on the state, and would worry more about the "right" placement decision. When choosing possible routes for a highway, it would be more likely to pick the most direct one—even if it ran through a middle or upper-class neighborhood—because it would not be overly concerned about the extra compensation involved. Rather, reimbursement would be the insurance companies' responsibility, not the state's. So, it is reasonable to believe that relatively more direct routes will be chosen, and that eminent domain will be exercised in a more distributively just manner, absent the financial burdens that affect current government incentives.<sup>352</sup> (However, if the government does not consider the financial impact on landowners at all and takes land in very wealthy neighborhoods even though the gain to society is small compared to a poorer neighborhood, the switch to takings insurance could lead to the state choosing less socially efficient locations for public projects than it does today.<sup>353</sup>)

On balance, however, a strong argument can be made that the availability of takings insurance as society's method of compensating for eminent domain will actually have a positive distributional effect on the choice of where land should be taken. Today, the state is incentivized to commandeer land in poor and minority areas, because its choice is between taking high-value property (and paying more for it) versus poor property (and paying less).<sup>354</sup> In response, we see highway and

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neighborhoods caused by highway construction, and highlights Lewis' conclusion that such " 'urban renewal' was likely racist." *Id.*

<sup>351</sup> See *id.* (stating that "in the minds of highway engineers, [exercising eminent domain in poor minority neighborhoods made sense because these areas] had the lowest property values and thus were the most practical buys for condemnation").

<sup>352</sup> While location incentives will probably be helped by the switch to takings insurance, the problem of "lack of voice" in poorer neighborhoods would likely not diminish considerably under the insurance alternative to government compensation.

<sup>353</sup> Hence, the argument offered in this section is actually not necessarily one in defense of the *efficiency* of takings insurance compared to state-based reimbursement. Rather, perhaps surprisingly to some observers, it is an indication that an insurance regime may in fact serve the interests of fairness and distributive justice far more than we do under today's status quo. An opposing argument could be made, however, that if the insurance industry is able to use its political power to capture eminent domain decision-makers, it will be able to dictate that takings of land still disproportionately occur in lower value neighborhoods—so as to minimize the insurance payouts necessary.

<sup>354</sup> See Feldstein, *supra* note 251, at 22; see also FROM TENEMENTS TO THE TAYLOR HOMES: IN SEARCH OF AN URBAN HOUSING POLICY IN TWENTIETH-CENTURY AMERICA (John

public transportation projects—like the Pasadena freeway<sup>355</sup> and Interstate 95 in Miami<sup>356</sup>—being built directly through less affluent minority neighborhoods even where that may not be the most efficient route.<sup>357</sup> Under a takings insurance system, the government will not worry about paying compensation, so it will be far more willing to take land wherever it is most justified for public use.

### 7. Social Acceptance Is Key

Despite the theoretical appeal that takings insurance possesses over our current government-based just compensation system, a switch to a private insurance market would not be an easy task to accomplish. Like so many other government programs, social acceptance is the key to success. Achieving

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F. Bauman et al. eds., 2000) (discussing the impact of interstate construction on housing in poor urban areas).

<sup>355</sup> The Pasadena freeway has been the subject of much controversy in southern California, as “South Pasadena residents have bitterly fought the roadway since the 1960s.” Neighboring El Sereno citizens joined the battle more recently when they filed a federal civil rights suit, alleging that the government granted the wealthier South Pasadena residents “design changes to alleviate the freeway’s impact, but did not do the same for El Sereno, a predominantly Latino community.” Joe Mozingo & Richard Winton, *Hundreds March Against 710 Freeway Extension*, L.A. TIMES, Mar. 8, 1998, at B3; see also George Ramos, *Unnatural Allies in a War Against a Common Enemy*, L.A. TIMES, Jan. 29, 1996, at B3 (noting that El Sereno is mostly Latino and that residents object that CALTRANS proposed to alleviate the freeway’s environmental impact for the white, affluent South Pasadena residents, including proposing an underground tunnel, but not for El Sereno citizens).

<sup>356</sup> See Milan Dluhy et al., *Creating a Positive Future for a Minority Community: Transportation and Urban Renewal Politics in Miami*, 24 J. URB. AFF. 75 (2002). The authors detail the plight of Overtown, once the center of African-American life in Miami, which lost 40% of its population when Interstate 95 was built through the heart of the community in the 1960s. *Id.* at 84. Even though a variety of non-policy factors played a role in the decline of the area, expressway construction and urban renewal greatly accelerated the process. *Id.* at 77. Just as important, efforts to mitigate the impact of the highway were delayed for many years in this minority community, thus magnifying the negative effects of government policies. *Id.* at 86–88.

<sup>357</sup> See *id.* at 77–83; see also Douglas P. Shuit, *Concerns Raised over Protecting Poor Communities: Justices’ Ruling May Weaken Suits Challenging Effects of Construction and Industry on Minority Areas*, L.A. TIMES, Apr. 28, 2001, at B4 (describing legal challenges to the Long Beach Freeway project and the Los Angeles International Airport expansion on grounds that they disproportionately impact poor and minority communities); see also Yumi L. Wilson, *Minority Coalition Sues over Freeway: Group Opposes Route of Cypress Replacement*, S.F. CHRON., Mar. 3, 1993, at A13 (covering the filing of a lawsuit against the replacement route for the earthquake-destroyed Cypress Freeway, contending that the chosen path would irreparably damage the minority community it runs through); Kevin Duchscher, *Minorities, Poor to Be Hurt by Wider 35W, Panel Told*, STAR TRIB. (Minneapolis), Aug. 6, 1992, at 1B (arguing that a “lopsided number of minority members, elderly and poor people would be hurt by the state Transportation Department’s proposal to expand Interstate Hwy. 35W”).

widespread public support for takings insurance would be challenging, because it is a radical idea at first blush. Moreover, amending the Constitution might prove nearly impossible. After all, who in Congress would support the taking of private property without the accompanying requirement that the state reimburse the owner for what it took? The notion that property ownership is among one's natural rights further complicates the practicality of any shift from state-based compensation to private insurance instead.

I recognize these arguments as serious obstacles to the takings insurance alternative to state-based reimbursement: without public "buy-in," there is little chance of success. If society were starting from scratch and considering the best possible eminent domain compensation policy, the advantages of takings insurance would be relatively compelling, and the program might fare quite well. But we are not starting from nothing. In a society where private property rights are considered sacred, it would be irresponsible to recommend abolishing the current system overnight.<sup>358</sup>

Instead, a change to takings insurance in lieu of state-paid compensation might be accomplished gradually, and be accompanied by widespread public education regarding the reasons for and benefits of the switch. Perhaps takings insurance would substitute for government compensation only in certain states at first,<sup>359</sup> or only for certain state actions—i.e., physical land takings only, and not regulatory ones.<sup>360</sup> Finally, even if social acceptance is never achieved, we must still take the lessons learned from this inquiry and apply them to the future development of eminent domain jurisprudence. At the very least, we should not take the government payment of just compensation for granted as we do today. There are other ways of compensating for takings that might better serve overall social welfare, and we owe it to society to consider them fairly.

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<sup>358</sup> Fritz Machlup eloquently made a similar point in the context of a government-run reward system substituting for our current patent laws: in theory, switching to such a system would increase social welfare. However, given that we have had a patent system for centuries that has achieved widespread social acceptance, it would be irresponsible to advocate its abolition. See STUDY OF THE SUBCOMM. ON PATENTS, TRADEMARKS & COPYRIGHTS OF THE COMM. ON THE JUDICIARY, 85TH CONG., 2D SESSION, AN ECONOMIC REVIEW OF THE PATENT SYSTEM 80, (Comm. Print 1958) (authored by Fritz Machlup); Calandrillo, *supra* note 231, at 357–58.

<sup>359</sup> Justice Brandeis was the first to famously refer to the states as great laboratories in need of the freedom to experiment. See *New State Ice Co. v. Liebmann*, 285 U.S. 262, 310–11 (1932) (Brandeis, J., dissenting). This suggestion of course runs afoul of the federal Constitution, but it is an interesting possibility from an academic perspective.

<sup>360</sup> See *infra* Part IV.



#### IV. THE SPECIAL PROBLEM OF REGULATORY TAKINGS

##### *A. Both Government Reimbursement and Takings Insurance Pose Difficulties*

Despite the appeal of an insurance market emerging as an alternative to the requirement that the government pay just compensation, there are several unique problems presented by regulatory takings that make it unlikely that takings insurance would be feasible in that context.<sup>361</sup>

##### *1. Can We Accurately Measure Changes in Value Attributable to Regulatory Takings?*

First, when states or municipalities pass regulatory ordinances in the valid exercise of their police power, it is often quite difficult to measure and verify the change in property value associated with the regulatory action.<sup>362</sup> For instance, a zoning ordinance that restricts land use to residential-only might decrease land value in certain areas, and increase fair market values in other locations. Many other government-based actions affect land values as well, such as the state's decision to construct roads, schools, prisons, malls, museums, libraries, etc. It would prove quite difficult to "net out" the effect that multiple government activities, regulatory or otherwise, had on a particular parcel's value when calculating compensation.<sup>363</sup> When all effects were summed up, it might even be the case that many landowners who were negatively affected by certain regulations wound up the net beneficiary of other government regulations. Would it be right to then ask those property owners to *reimburse the government*?<sup>364</sup>

Even if it were conceded that a regulation decreased one's land value, the task of measuring that incremental decline would not be an easy one.<sup>365</sup>

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<sup>361</sup> See Blume & Rubinfeld, *supra* note 137, at 593–97.

<sup>362</sup> See Congressional Budget Office, *Regulatory Takings and Proposals for Change* (1998), available at <http://www.cbo.gov/showdoc.cfm?index=1051&sequence=0> (last visited Apr. 7, 2003).

<sup>363</sup> See SHAVELL, *supra* note 39, § 6, at 7.

<sup>364</sup> Cunningham, Stoebeck, and Whitman note that in the physical land takings context, some jurisdictions allow the value of the intended public project to offset the landowner's "severance damages" recovery when she keeps part of her land and the government takes the other portion. However, in many jurisdictions, offsetting benefits are considered only to the extent that they are "special" benefits—that is, those that accrue peculiarly to one owner or only to a few similarly situated owners and not generally to large numbers of people. See CUNNINGHAM ET AL., *supra* note 81, at 512 n.33. Analogously, should the government demand compensation from those individuals who have seen their home values rise because of regulatory actions? That would certainly be a tremendously hard sell to the American public.

<sup>365</sup> See SHAVELL, *supra* note 39, § 6, at 7.

Regulations often do not remove the full value of property, whereas physical takings by definition do—one no longer owns her land. This functional distinction helps explain the dichotomy in current Supreme Court takings jurisprudence.<sup>366</sup> With respect to physical land takings, there is no question that full value has been deprived, so that is the appropriate compensatory measure. Further, to ease this measurement, the real estate industry has developed methods that quite accurately calculate the fair market value of particular land parcels, and hence, the government need only pay that amount.<sup>367</sup> With respect to regulatory takings, however, it is less clear what the financial effect is on the precise value of a piece of land.<sup>368</sup> There is thus greater concern about arbitrariness and inaccuracy creeping into the valuation of such takings. The Supreme Court responded first to this concern with *Penn Central Transportation*<sup>369</sup> and then with the *Lucas* standard—a deprivation of substantially “all economically beneficial or productive use of land” was required before the government would pay just compensation.<sup>370</sup> This is simply an administratively efficient compromise to the reimbursement problem: society is concerned about the difficulty involved in calculating uncertain incremental changes in value due to regulation, so we often choose not to compensate for them at all. Only if virtually *all* of one’s land value is taken away do we compensate. Well, this was true until the *Tahoe* case came along last year, and demanded *permanent* deprivation of all economic value.<sup>371</sup>

Yet the reasoning of *Tahoe* contains merit. Since it is quite difficult to measure net changes in land values associated with many regulatory actions, society chooses not to get involved in the quagmire by infrequently offering compensation for them.

Similarly, insurance-based reimbursement for regulatory takings in lieu of government-paid compensation would face the same pitfalls that state-based

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<sup>366</sup> See *Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg’l Planning Agency*, 535 U.S. 302, 323 (2002).

<sup>367</sup> For example, real estate agencies use home pricing indices, comparable home sales, and past and present valuation data to fairly and accurately estimate property values. See *US Home Value*, *supra* note 293. Still, many disputes over the proper calculation of fair market value do occur, and several commentators argue that fair market value is indeed too low to adequately compensate displaced landowners. See, e.g., Knetsch & Borcharding, *supra* note 73, at 241–42.

<sup>368</sup> See *Tahoe*, 535 U.S. at 320.

<sup>369</sup> *Penn Central Transportation* was the first Supreme Court holding to move away from the absolute requirement of “physical invasion” of land before a taking could receive compensation. Instead, the Court laid down a three-factor balancing test to aid in the determination of whether certain regulatory actions amounted to constitutional takings requiring reimbursement. See *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978).

<sup>370</sup> *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1015 (1992); *supra* Part II.D.

<sup>371</sup> See *Tahoe*, 535 U.S. at 332; *supra* Part II.D. The *Tahoe* Court held that a thirty-two month moratorium on development failed to meet the “permanency” requirement for a regulatory taking to be compensable.

payment would. Private insurance firms would be left wondering what the cumulative economic effect of multiple government actions were on insured property. Accordingly, insurance payouts for regulatory takings would frequently be subject to landowner dispute and debate. The uncertainty surrounding valuation and the challenges that companies would face in satisfying insured customers would inevitably lead to additional administrative costs that might render insurance unworkable in the regulatory context. Of course, statistical analysis might evolve to better sort out the net effect of government regulatory actions, especially where a sudden drop in land values came immediately on the heels of a city zoning change.<sup>372</sup> On net, however, problems in regulatory valuation would likely never be solved to everyone's satisfaction, and we might be better off as a society with neither just compensation nor insurance-based reimbursement of such takings.

## *2. Actors Facing Regulatory Risks are Often Risk-Neutral*

Second, to the extent that the purpose of mandatory government payment of just compensation is based on the principle of insuring landowners against unpleasant risks,<sup>373</sup> that purpose is less dominant with respect to regulatory takings.

Generally, it is thought that actors facing the prospects of regulatory actions—like zoning ordinances restricting commercial development—are disproportionately corporations, large businesses and relatively wealthy landowners.<sup>374</sup> The argument is that on average these organizations and individuals are thought to be less risk averse than small property owners are. In fact, they may even be perfectly risk-neutral because of the greater financial resources at their disposal. Hence, they can effectively self-insure against the risk of regulatory takings because it is analogous to the many other business risks they face everyday. Adverse regulatory actions are simply one more expected liability in their cost-benefit calculus regarding whether to purchase and develop a particular piece of property. The need for compensation or insurance to protect these large property owners against risk is thus considerably mitigated.

The same cannot be said of the individual small parcel landowner, whose entire wealth may reside in her land. Without government compensation or insurance, a physical taking of her land could be devastating. Fortunately, such small owners are not often affected by regulatory takings (especially prohibitions on commercial development), and therefore the requirement of compensation,

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<sup>372</sup> See SHAVELL, *supra* note 39, § 6, at 7.

<sup>373</sup> See Farber, *supra* note 137, at 286 (noting that the insurance rationale for takings law is frequently attributed to Michelman's classic article on just compensation); Michelman, *supra* note 188, at 1214–17 (discussing the demoralization costs associated with eminent domain actions).

<sup>374</sup> See SHAVELL, *supra* note 39, § 6, at 7.

either by the state or through insurance, is less necessary than one might initially think.

### 3. *Moral Hazard and Adverse Selection in the Regulatory Insurance Market*

Of greater concern, Blume and Rubinfeld argue that the moral hazard and adverse selection problems might prove quite troublesome for the prospect of workable regulatory takings insurance.<sup>375</sup>

Imagine a property owner who purchased insurance against the chance that a state regulatory action would deprive her of a portion of the economic value of her property. Since she knows that she will be compensated for any decrease in fair market value, she may have an increased incentive to allow her land to deteriorate when a regulation or negative zoning ordinance appears imminent.<sup>376</sup> Failing to maintain her land may require expensive regrading or planting by potential buyers, and will certainly reduce its value further than the regulatory action alone would have. However, the property owner may bank on the receipt of guaranteed compensation, and hope that the insurance company will *think* that it was the zoning regulation that caused the full decline in value—because it is very difficult to measure and monitor all the actions the owner has taken, and the exact decline caused by regulatory events.<sup>377</sup> Hence, any drop in land value will be reimbursed by the insurer even though the full amount of the decrease was much larger than the portion attributable to the regulatory taking alone.

Thus, the moral hazard of landowners in this context will make the provision of regulatory takings insurance very difficult to administer and control.<sup>378</sup> As Blume and Rubinfeld discuss, the “source of [the insurance market] imperfection . . . occurs when the party to be insured can affect the probability or the magnitude of the event that triggers payment.”<sup>379</sup> Premiums will necessarily increase to the extent that insurance companies are unable to monitor and deter property owners from taking actions which decrease the value of insured land. Property owners relying on guaranteed compensation may be encouraged to engage in socially unproductive actions, causing insurance to be more expensive than it is worth, eventually leading to the unraveling of the entire market.<sup>380</sup>

Blume and Rubinfeld are thus correct that moral hazard difficulties might prevent a private regulatory takings insurance market from developing. However, this in itself is not a reason for the government to supply public insurance in the

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<sup>375</sup> See Blume & Rubinfeld, *supra* note 137, at 593–97.

<sup>376</sup> See SHAVELL, *supra* note 39, § 6, at 7.

<sup>377</sup> See *id.*

<sup>378</sup> See Blume & Rubinfeld, *supra* note 137, at 593–95.

<sup>379</sup> *Id.* at 593.

<sup>380</sup> See *id.* at 594–97.

form of just compensation. If moral hazard is a significant problem, then it is not socially desirable at the outset for there to be much of an insurance market—either private or *public*. Simply put, it would be a mistake for the state to provide insurance (i.e., compensation for takings) where the market itself does not supply it due to the moral hazard dilemma—because the government would suffer from the same difficulties in its administration as a private insurer would.<sup>381</sup>

Conversely, the moral hazard risk appears to be somewhat less substantial in the context of physical land takings than it does with respect to regulatory actions. If the state physically takes all of one's land, the insurance company would reimburse the owner for the property's full fair market value *ex ante*. It matters far less whether the owner takes steps to preserve land value once she is informed of the imminent eminent domain action—because all of her property will be destroyed regardless of her behavior. Therefore, landowners facing physical land takings will have substantially less influence on whether and on how much of their insurance gets used, allowing a takings insurance market in that area to function more efficiently than its regulatory counterpart.

Furthermore, adverse selection would also likely occur in the regulatory takings insurance market. Adverse selection refers to the tendency of insurance companies to attract the riskiest customers: obviously, life insurance is more valuable to the terminally ill than it is to a healthy teenager.<sup>382</sup> Similarly, Blume and Rubinfeld contend that individuals with inside knowledge regarding the actual possibility of a taking (or at least better information than the insurance firm possesses) will be the ones who disproportionately purchase takings insurance. For instance, owners of wetlands or shoreline areas are generally aware that their property may eventually face restricted development, as perhaps were the landowners in the ecologically sensitive Lake Tahoe Basin at the heart of the *Tahoe* case. These individuals will have significantly more incentive to purchase regulatory takings insurance than property owners not situated in these areas, leading to a pool of insureds that are substantially more risky (and expensive to cover) than the general land-owning population. If insurers are primarily covering this type of high-risk property, they will shortly go out of business.<sup>383</sup>

Hence, the adverse selection dilemma in the context of regulatory actions seems particularly problematic. In comparison, while some degree of adverse selection would likely exist in the market for physical land takings insurance, it is not as clear that the risk of outright eminent domain actions of this type are

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<sup>381</sup> The *Tahoe* decision limiting compensation for regulatory takings makes good economic sense from this perspective, although this moral hazard argument was not made explicitly by Justice Stevens. See *Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency*, 535 U.S. 302, 341 (2002).

<sup>382</sup> See Farber, *supra* note 137, at 284.

<sup>383</sup> *But cf. id.* (noting that insurers could counter the adverse selection problem by keeping informed as to local political developments regarding possible eminent domain actions, and by requiring that insurance coverage be purchased well in advance of the taking).

concentrated on only a select few property owners (who would be disproportionately incentivized to purchase insurance). The pool of insureds would potentially include all property owners wherever they might be and whatever their respective risk, allowing an insurance market to function more successfully.

This economic theory explanation regarding the potential market failures associated with regulatory takings insurance appears to be borne out by the current state of the insurance market. Today, there is little (if any) insurance sold against government regulations that lower market value,<sup>384</sup> even though one might think that some landowners would benefit from the purchase of such insurance. Its absence is a testament to the practical difficulties in valuing, administering and monitoring such a system, rather than any principled notion that aggrieved landowners should not be justly compensated. Moreover, if moral hazard prevents the efficient operation of a private insurance market covering regulatory takings, it would be a mistake to take this as a reason for the government to offer compensation instead—because the state would be subject to the same dilemmas and inefficiencies.

### B. Conclusion with Respect to Regulatory Takings

Given the unique valuation and administration issues associated with regulatory actions, it is economically understandable why the *Tahoe* Court was reluctant to mandate government compensation for regulatory takings, except in extreme circumstances.<sup>385</sup> Whether or not state-based just compensation is required or private takings insurance is offered instead, it would prove quite difficult to measure the decline in land value attributable to the myriad regulatory actions that the government takes everyday.<sup>386</sup> Uncertainty in valuation would undermine confidence in the resulting compensation paid, leading to inevitable disputes and increased administrative costs.<sup>387</sup> Further, insuring against regulatory actions is probably less necessary than that of physical land takings because regulatory risks are often placed on corporations, businesses or wealthy commercial developers. These entities are generally thought to be less risk-averse

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<sup>384</sup> See Bell & Parchomovsky, *supra* note 262, at 308.

<sup>385</sup> See *Tahoe*, 535 U.S. at 325 n.19 (noting that the *Lucas* holding is a “narrow exception to the rules governing regulatory takings[,]” and that just compensation is reserved for the “‘extraordinary circumstance’ of a permanent deprivation of all beneficial use”).

<sup>386</sup> See *id.*

<sup>387</sup> See Congressional Budget Office, *supra* note 362. The 1998 CBO study detailed many of the problems that landowners face when attempting to recover compensation for regulatory actions, and proposed several innovative solutions. One interesting notion was that government agencies who engaged in regulatory takings should have the direct responsibility to pay compensation out of the agency’s own budget—an attempt to impose some fiscal discipline and to limit excessive eminent domain actions.

than their individual property owner counterparts, and correspondingly have a reduced need to be insured by a third party.<sup>388</sup> Finally, moral hazard and adverse selection in the regulatory takings insurance market might prevent its efficient operation.<sup>389</sup> In the end, premiums would theoretically increase beyond the optimal level and only the riskiest landowners would purchase coverage, potentially leading the entire regulatory insurance market to collapse.

More concretely, now that *Tahoe* has been decided, we will see in fact whether an insurance market emerges to serve the regulatory takings context. Previously, there was little need for one because landowners who were deprived of substantially all economically beneficial use of their property received government compensation for their loss.<sup>390</sup> As such, critics who pointed to the absence of takings insurance as proof that such a scheme was unworkable were off-base. There was simply not enough need to justify it in the world governed by *Lucas*. However, once the ramifications of *Tahoe* become clear, we might very well see some market mechanism attempt to provide reimbursement against certain regulatory takings. Whether it will succeed in this arena—given the serious adverse selection, moral hazard and measurement problems detailed above—is quite another matter.

## V. CONCLUSION

In the final analysis, we all understand that the government exercise of eminent domain is often necessary to serve the greater public good. The accompanying requirement of mandatory state payment of just compensation is often taken for granted even though we owe it to ourselves as a society to consider ways to improve the reimbursement system. Upon examination, it is not clear that government reimbursement for land takings is necessarily the best way of making displaced landowners whole. The state faces significant administrative costs in operating the eminent domain compensation system, costs that might be reduced by a private takings insurance alternative.<sup>391</sup> More importantly, the guarantee of government-paid compensation inadvertently induces property owners to act in socially undesirable ways. Landowners are encouraged to excessively invest in their property even in the face of looming eminent domain actions because they know that reimbursement for the increased property value will be due to them regardless of whether the state eventually decides to take their land and demolish their improved structures.<sup>392</sup> In the physical land takings

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<sup>388</sup> See SHAVELL, *supra* note 39, § 6, at 7.

<sup>389</sup> See Blume & Rubinfeld, *supra* note 137, at 594–96.

<sup>390</sup> See *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1030 (1992).

<sup>391</sup> See *supra* Parts III.B.2, .3.

<sup>392</sup> See *supra* Part III.B.1.

context, private insurance can better prevent this problem by adjusting premiums charged to reflect the increased expected liability of one's actions.

However, we now see clearly in the regulatory takings arena that the Supreme Court and the government are increasingly reluctant to reimburse for diminution in property values caused by certain actions,<sup>393</sup> often upholding zoning ordinances—without requiring compensation to affected parties—that substantially impact the economic usefulness of property. It is difficult to justify the *Tahoe* Court's treatment of regulatory takings on fairness grounds, because affected landowners are frequently deprived of the great majority of the beneficial use of their land and yet are still denied compensation. While this outcome fails to make intuitive sense initially, it is far more understandable from a functional economic perspective. It is simply impractical to accurately measure all of the changes in property values due to the broad range of state regulatory actions and to administer a fair and efficient compensation regime.<sup>394</sup> This is true whether or not the compensation is provided by the government or by a private takings insurance market instead.

So, in the end, what should we do about takings jurisprudence in America? Should we simply maintain the status quo? For physical takings, I argue that change may be in our best interest. The benefits of privately provided takings insurance to compensate aggrieved landowners appear to outweigh those of government-based compensation.<sup>395</sup> All kinds of insurance are widely available today—homeowner's, life, disability, etc.—there is no principled reason why a takings insurance market would not emerge to replace the government's obligation of just compensation.<sup>396</sup> Taxes that currently flow to the state to fund the exercise of eminent domain would be saved, and could then be allotted to the purchase of insurance against the risk of land takings. In this manner, property owners would be left no worse off financially (on average), and the perverse incentive to improve their land in the face of potential state eminent domain actions would be substantially reduced.<sup>397</sup>

However, for regulatory takings, there is no easy solution to our tortured Supreme Court jurisprudence. It has become quite difficult to receive compensation for regulatory actions now that *Tahoe* has been decided,<sup>398</sup> but that may be for the best. Regulatory takings are notoriously difficult to value, many of the actors facing them are not particularly risk averse, moral hazard of affected

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<sup>393</sup> See *Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency*, 535 U.S. 302, 322–23 (2002).

<sup>394</sup> See *id.*; see also *supra* Part IV.A.

<sup>395</sup> See *supra* Part III.D.

<sup>396</sup> See SHAVELL, *supra* note 7, § 11, at 13–14.

<sup>397</sup> See *supra* Part III.D.1.

<sup>398</sup> See *Tahoe*, 535 U.S. at 332 (rejecting the categorical rule of regulatory takings handed down in *Lucas*).



landowners is likely to be a significant problem, and hence payouts of compensation should be limited.<sup>399</sup> A standard that restricts reimbursement to situations involving permanent economic deprivation makes sense from an administrative perspective, although courts will now be called into inevitable line-drawing battles over what regulations meet this high threshold.

We must admit, however, that there is no fairness-based distinction governing the differential treatment accorded physical versus regulatory takings in America. In both scenarios, property owners are often left with substantially reduced or no land value remaining, but economic and functional realities dictate that the two must be addressed differently. In the regulatory arena, private insurance would probably not function much better than state payment of compensation due to potential moral hazard and adverse selection on the part of landowners. Hence, takings insurance is an unlikely solution to the unsatisfactory history of regulatory takings jurisprudence.<sup>400</sup>

Nevertheless, we must take the lessons learned in analyzing the power of eminent domain and our system of just compensation to devise ways to improve social welfare in the future. We should no longer take the current reimbursement structure as a given, and instead we must analyze ways it can be made more efficient. At least in the physical land takings context, private insurance might indeed function more effectively than state-based compensation. Achieving social acceptance of this alternative will be our next great challenge.

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<sup>399</sup> See *supra* Part IV.A.

<sup>400</sup> See *supra* Part IV.B.